PETITION AND TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, [redacted] 1926

No. [redacted] 289

THE UNITED STATES, PETITIONER

vs.

CHARLES A. LUDEY

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

PETITION FOR CERTIORARI FILED FEBRUARY 4, 1926

CERTIORARI GRANTED APRIL 19, 1926

(31676)

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1925

No. 953

THE UNITED STATES, PETITIONER

vs.

CHARLES A. LUDEY

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

INDEX

95142—26——1

A In the Supreme Court of the United States

October term, 1925

No. ——

United States of America, petitioner

v.

Charles A. Ludey

Petition for writ of certiorari to the United States Court of Claims

The United States of America prays that a writ of certiorari issue to the United States Court of Claims directing that court to certify to this court the record in the case of Charles A. Ludey v. The United States, No. D-360 in that court, in order that the decision and judgment of said court, rendered on November 9, 1925, may be reviewed.

STATEMENT OF THE CASE

This suit was to recover taxes paid under protest, and claimed to have been illegally assessed, and claim for refund of which had been denied.

B The findings of the Court of Claims show that Charles A. Ludey filed a return of his income for the calendar year 1917. In this return he claimed as a deduction from gross income an alleged loss upon the sale of certain oil properties, some of which were acquired before and some after March 1, 1913. The claimant contended in his petition that the loss was more than that claimed in his return, namely, \$14,777.33. The Commissioner of Internal Revenue found that claimant derived a taxable profit of \$26,904.15 on such sales.

The sale out of which the commissioner held that a gain arose was of certain oil property designated in the pleadings as:

(1) The Goodman fee and Matney lease,
(2) The Wolf lease,
(3) The Billingslea lease,
(4) The Pittman fee, and
(5) The Helphrey oil drilling rig.

Item No. 1, the Goodman fee and the Matney lease were purchased prior to March 1, 1913, at \$20,000. They were worth on March 1, 1913, \$47,500, and between March 1, 1913, and the date of sale equipment and improvements had been added at a cost of \$6,000. The remaining property, items Nos. 2, 3, 4, and 5 were acquired after March 1, 1913, at a total cost, including subsequent improvements, of \$42,477.33. The entire property was sold in 1917
C for \$81,200. Between March 1, 1913, and the date of sale these properties had been operated by the claimant and certain oil had been extracted. The value of the oil thus extracted was \$32,253.81. During the same period the equipment had been used by the claimant and had depreciated by wear and tear to the

extent of $10,465.16. In calculating the gain derived from this transaction the commissioner determined that the decrease by reason of the depletion of the oil reserves and the depreciation from wear and tear should be deducted from the cost of the property sold before determining whether there was a gain. The claimant in arriving at a loss from this transaction deducts nothing for the depletion of the oil reserves and nothing for the wear and tear of the equipment.

The Court of Claims held that the Government's depletion and depreciation adjustments on sale of property in 1917 were erroneous.

THE STATUTES

Title I, act of September 8, 1916 (chap. 463, 39 Stat. 756), as amended by the act of October 3, 1917 (chap. 63, 40 Stat. 300, 329), provides:

"SEC. 1. (a) That there shall be levied, assessed, collected, and paid anually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income * * *.

D "(b) In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax) there shall be levied, assessed, collected, and paid upon the total net income of every individual, or, in the case of a nonresident alien, the total net income received from all sources within the United States, an additional income tax (herein referred to as the additional tax) of one per centum per annum upon the amount by which such total net income exceed $20,000 and does not exceed $40,000 * * *.

"(c) The foregoing normal and additional tax rates shall apply to the entire net income, except as hereinafter provided, received by every taxable person in the calendar year nineteen hundred and sixteen and in each calendar year thereafter.

"SEC. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or compensation for personal service of whatever kind and in
E whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * * * *

"(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen

hundred and thirteen, shall be the basis for determining the amount of such gain derived.

"SEC. 5. That in computing net income in the case of a citizen or resident of the United States—

"(a) For the purpose of the tax there shall be allowed as deductions—

* * * * * * *

"Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not com-
F pensated for by insurance or otherwise: Provided, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

"Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom * * *.

"SEC. 1. WAR INCOME TAX (chap. 63, 40 Stat. 300).—That in addition to the normal tax imposed by subdivision (a) of section one of the act entitled 'An act to increase the revenue, and for other purposes,' approved September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like normal tax of two per centum upon the income of every individual, a
G citizen or resident of the United States received in the calendar year nineteen hundred and seventeen and every calendar year thereafter.

"SEC. 2. WAR INCOME TAX.—That in addition to the additional tax imposed by subdivision (b) of section one of such Act of September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like additional tax upon the income of every individual received in the calendar year nineteen hundred and seventeen and every calendar year thereafter, as follows:

"One per centum per annum upon the amount by which the total net income exceeds $5,000 and does not exceed $7,500 * * *."

Title II, act of October 3, 1917 (chap. 63, 40 Stat. 303), provides:

"SEC. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, part-
H nership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:

"Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year * * *."

THE ISSUES

I. In computing the gain derived from a sale of capital assets does the revenue act of 1916, as amended by the revenue act of 1917, require that the cost or the March 1, 1913, value be reduced by depletion and depreciation sustained?

II. Where property is acquired prior to March 1, 1913, and the sale price is greater than the cost but less than the March 1, 1913, value, is a loss sustained under the provisions of the revenue act of 1916, as amended by the revenue act of 1917?

REASONS FOR GRANTING THE PETITION

1. In the view of the petitioner the Court of Claims erred in holding as follows:

(a) That in determining gain or loss of owner or lessee upon the sale of oil rights, depletion sustained or previously allowed for oil extracted may not be subtracted from the cost price in determining gain or loss upon sale in 1917.

(b) That depreciation sustained or previously allowed should not be subtracted from the cost price in determining a gain or loss in 1917.

(c) That, on properties purchased prior to March 1, 1913, no taxable gain or taxable loss resulted where the selling price in 1917 was less than the March 1, 1913, value thereof, but was greater than the cost.

(d) That as to properties purchased subsequent to March 1, 1913, the facts show a loss thereon.

2. The determination of the questions involved herein vitally affects the rules followed by the Internal Revenue Bureau since the inception of income taxation. The decision of the Court of Claims is antagonistic to these rules, which have been generally acquiesced in by taxpayers. A change in the rules at this time would affect all years previous to the effective date of the revenue act of 1924, which makes specific provision for such cases. An ascertainment of the amount of taxes in other cases dependent upon the correctness of the Government's position is not possible, but, without question, it runs into many millions of dollars.

The rule followed by the Government has been approved by the Board of Tax Appeals. (Even Realty Company, 1 B. T. A. 355.)

Wherefore it is respectfully submitted that this petition for writ of certiorari to review the judgment of the United States Court of Claims should be granted.

WILLIAM D. MITCHELL,
Solicitor General.

HERMAN J. GALLOWAY,
Assistant Attorney General.

FRED K. DYAR,
Special Assistant to the Attorney General.

JANUARY, 1926.

1 In Court of Claims of the United States of America

CHARLES A. LUDEY, *against* THE UNITED STATES OF AMERICA.	D-360

I. *Petition*

Filed June 5, 1924

To the Court of Claims of the United States and to the Honorable the Judges Thereof:

The above named claimant, by Johnson & Shores, his attorneys, by this his petition respectfully shows:

1. The claimant at all times hereinafter mentioned was and is a citizen of the United States and a resident of the city of Parkersburg, county of Wood, State of West Virginia.

2. The claimant has a just claim for the refund of $11,715.45 paid by him to the collector of internal revenue for the district of Oklahoma as income and excess profits taxes wrongfully assessed by the Commissioner of Internal Revenue of the United States for the taxable year ending December 31, 1917, with interest thereon.

The provisions of law under which such taxes were wrongfully assessed and collected and upon which the claimant claims
2 such refund are sections 1, 2, and 5 of Title I of the revenue act of September 8, 1916, as amended by the revenue act of October 3, 1917, and section 201 of Title II of the revenue act of October 3, 1917.

3. Pursuant to section 3173 of the Revised Statutes and other acts of Congress provided, the claimant on or about March 23, 1918, on official Forms No. 1040 and No. 1101, made to the Commissioner of Internal Revenue his income and excess profits tax returns for the taxable year ending December 31, 1917, for the taxes imposed by said sections 1, 2, 5, and 201. In said income tax return claimant's net taxable income for the taxable year ending December 31, 1917, was stated to be $30,594.33.

4. Upon said income tax return income taxes in the sum of $2,110.15 were assessed against claimant on or about June 1, 1918. The claimant duly paid to the collector of internal revenue for the district of Oklahoma the said sum of $2,110.15 on or about June 15, 1918.

5. In determining his net taxable income reported in said returns for 1917 the claimant deducted $7,621.33 as a loss sustained upon the sales by claimant in February, 1917, of certain oil lands, leases and properties, to wit: the fee to Goodman farm, a lease to Matney farm, a lease to Wolfe farm, a lease to Billingslea farm, the fee to Pitman farm, and a one-third interest in Helphrey oil drilling rig.

The said Goodman fee and Matney lease were purchased by claimant in 1911 at an aggregate purchase price of $20,000 and had on

March 1, 1913, an aggregate fair market value, with physical equipment, of $47,500, of which $39,500 was the value of oil reserves and $8,000 the value of physical equipment. Subsequent to March
3 1, 1913, there were added by claimant to said Goodman farm equipment and improvements at a cost of $6,000.

The said Wolfe lease was purchased by claimant in July, 1913, for $26,500.00, of which $17,500 was paid for oil reserves and $9,000 for physical equipment, and thereafter equipment and improvements were added thereto by claimant at a cost of $1,794.00.

The said Billingslea lease was purchased by claimant in December, 1913, for $11,000, of which $5,000 was the value of the oil reserves and $6,000 the value of the physical equipment.

The said Goodman fee, Matney lease, Wolfe lease, and Billingslea lease were sold by claimant in February, 1917, for an aggregate sales price of $76,500.

The said Pitman fee was purchased by claimant in February, 1915, for $3,000 and was sold by claimant in 1917 for $4,500.

The said one-third interest in Helphrey oil drilling rig was purchased by claimant in 1916 for $183.33 and was sold by claimant in 1917 for $200.

Computed in accordance with the provisions of said revenue act of 1916, claimant sustained a loss of $14,777.33 on said sales, wherefore claimant's net taxable income for the taxable year ending December 31, 1917, amounted to $23,438.33, and the income and excess profits taxes lawfully assessable on said returns amounted to $1,251.36.

6. By letter dated January 16, 1923, the Commissioner of Internal Revenue notified the claimant that an additional assessment of income and excess profits taxes amounting to $10,856.66 would be listed against the claimant for the taxable year ending December 31, 1917.

4 7. Following such notice, and on November 5, 1923, the collector of internal revenue for the district of Oklahoma made unlawful demand upon claimant for the payment of $10,856.66 as additional income and excess profits taxes for the taxable year ending December 31, 1917, determined as described in the letter of the Commissioner of Internal Revenue, dated January 16, 1923, referred to in paragraph 6 hereof.

8. On November 9, 1923, the claimant under the threat of said collector of penalties if claimant failed to make such payments, and in the belief that such threat would be carried out, paid to the said collector at Oklahoma City, Oklahoma, the said sum of $10,856.66. The said payment was made under duress and protest, and at the time of making such payment the claimant filed with the said collector a written protest against such additional assessment and against the enforced payment thereof. A copy of such protest, marked "Exhibit A," is attached hereto and made a part hereof.

9. On information and belief the claimant avers that the sum of $12,966.81 so paid by claimant to the said collector was there-

after by the said collector turned over and deposited into the Treasury of the United States of America as in the usual course of his official business.

10. On November 12, 1923, pursuant to section 3220 of Revised Statutes, and other acts of Congress provided, the claimant duly filed with the said collector a claim for refund of $10,856.66 or such greater amount as was legally refundable. A copy of said claim for refund, hereto attached and marked "Exhibit B," is made a part of this petition.

5 The taxes, refund of which was so claimed, resulted from the unlawful rejection and disallowance by the Commissioner of Internal Revenue of $14,777.33, the loss sustained by claimant on the sale of the oil properties above described, and from the erroneous finding by the Commissioner of Internal Revenue that claimant sustained no loss, but derived a profit of $26,904.15 from the sale of said oil properties.

11. On March 20, 1924, claimant's said claim for refund was rejected by the Commissioner of Internal Revenue, and the sum of $11,715.45 is now wrongfully and unlawfully retained and withheld from the claimant without his consent and against his will by the United States of America.

12. No other action than as aforesaid has been had on this claim in Congress or in any of the departments. The claimant has at all times borne true allegiance to the Government of the United States. He has not in any way voluntarily aided, abetted, or given encouragement to rebellion against such Government. He is and always has been the sole and absolute owner of the claim here presented. He has made no transfer or assignment of said claim or of any part thereof, or of any interest therein. He is justly entitled to the amount claimed from the United States of America, after allowing all just credits and offsets.

13. Claimant believes the facts as herein stated to be true.

Wherefore the claimant prays for judgment against the United States of America upon the facts and the law for $11,715.45, together with interest on $858.79 from June 15, 1918, and
6 interest on $10,856.66 from November 9, 1923, and his reasonable costs and disbursements herein.

Charles A. Ludey, *Claimant.*
Johnson & Shores,
By Wayne Johnson,
Member of Firm.
Johnson & Shores,
Attorneys for Claimant,
Office & P. O. Address, 100 Broadway,
Borough of Manhattan, City and State of New York.

[*Duly sworn to by Charles A. Ludey; jurat omitted in printing.*]

7 *Exhibit A to petition*

PROTEST

This payment is made under duress and compulsion of threatened distraint and penalties, solely to avoid such distraint and penalties and under specific protest that the tax demanded is illegal and not computed in accordance with law. I specifically protest that the tax is illegal in the following particulars:

The Bureau of Internal Revenue has computed the profit resulting from the sale of my oil properties by reducing the cost and March 1, 1913, value thereof by the depletion sustained prior to the date of such sale and has erroneously treated as profit the difference between such depleted cost and March 1, 1913, value and the total consideration received by me. I contend that in determining the profit from such sale the cost and March 1, 1913, value should not be reduced by the amount of depletion sustained. I further contend that the additional tax is illegal in that the bureau has computed the depletion allowance to me by the unit or present value method, whereas such depletion allowance should be computed according to the actual reduction in flow and production as provided by law.

And I further contend that said additional tax is illegal and not properly assessed for other reasons not here specifically stated.

CHARLES A. LUDEY.

MARIETTA, OHIO, *November 5, 1923.*

8 *Exhibit B to petition*

CLAIM FOR

TREASURY DEPARTMENT. Internal Revenue Service. Form 843—Jan., 1922. Comptroller General, U. S., January 18, 1922.	Abatement of tax assessed Credit against outstanding assessments xRefund of taxes illegally collected Refund of amounts paid for stamps used in error or excess	COLLECTOR'S NOTATION District Account number Date received
IMPORTANT File with collector of internal revenue where assessment was made. Not acceptable unless completely filled in. NOTICE TO COLLECTOR Collector must indicate in block above the kind of claim, except in income-tax cases.	Date received by Administrative unit Stamp here	Stamp here ____________________ Collector of internal revenue

STATE OF OHIO,
County of Washington, ss:

CHARLES A. LUDEY
(Name of taxpayer or purchaser of stamps)

PRINT OR TYPE

Marietta, Ohio.
(Residence—give street and number as well as city or town and State)

\-
(Business address)

This deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below with reference to said statement are true and complete:

	Period	Year
	From January	1, 1917
	To December	31, 1917

1. Business in which engaged: Oil operator.
2. Character of assessment or tax: Additional income and profits taxes.

(State for or upon what the tax was assessed or the stamps affixed)

3. Amount of assessment or stamps purchased------- $10,856.66
4. Reduction of tax liability requested (income and profits tax) -- $10,856.66
5. Amount to be abated----------------------------- $--------
6. Amount to be refunded (or such greater amount as is legally refundable)------------------------- $10,856.66

9 7. Dates of payment (see collector's receipts or indorsements of canceled checks), November 9, 1923.

(If statement covers income tax liability, items 8–11, inclusive, must be answered)

8. District in which return (if any) was filed: Oklahoma.
9. District in which unpaid assessment appears: Oklahoma.
10. Amount of overpayment claimed as credit------ $----------
11. Unpaid assessment against which credit is asked; period from ------------------------------------ $----------

Deponent verily believes that this application should be allowed for the following reasons:

The additional assessment is erroneous in that the Bureau of Internal Revenue computed the profit resulting from the sale of deponent's oil properties by reducing the cost and March 1, 1913, value thereof by the depletion sustained prior to the date of such sale and erroneously treated as profit the difference between such depleted cost and March 1, 1913, value and the total consideration received by deponent. Deponent contends that in determining the profit from such sale the cost and March 1, 1913, value should not be reduced by the amount of depletion sustained.

The additional assessment is further erroneous in that the bureau computed the depletion allowance to this taxpayer by the unit or present value method, whereas such depletion allowance should be computed according to the actual reduction in flow and production as provided by law.

(Attach additional sheets if necessary)

(Signed) CHARLES A. LUDEY.

Sworn to and subscribed before me this 10th day of November, 1923.

EZRA MILLER, *Notary Public.*
(Title)

(This affidavit may be sworn to before a deputy collector of internal revenue or revenue agent without charge)

10 II. *General traverse*

Aug. 5, 1924

No demurer, plea, answer, counterclaim, set-off, claim of damages, demand, or defense in the premises having been entered on the part of the defendant, a general traverse is entered as provided by rule 34.

III. *History of proceedings*

On February 3, 1925, this case was argued and submitted on merits by Mr. Wayne Johnson, for the plaintiff, and by Mr. Thomas H. Lewis, jr., for the defendant.

On May 11, 1925, the court filed findings of fact, with an opinion by Judge Graham, together with the following order: "It is ordered by the court that this case be and it is remanded for a stipulation or evidence as to the amount of a judgment that should be rendered for the plaintiff under the conclusions stated in the court's opinion."

On June 9, 1925, the claimant filed a motion to amend findings of fact and opinion.

On the same day a stipulation for judgment in compliance with the order of court issued May 11, 1925, was filed.

On Nov. 9, 1925, the court entered the following order:

"Order

It is ordered by the court this 9th day of November, 1925, that the plaintiff's motion to amend findings and opinion be and the same is allowed in part and overruled in part.

The former findings, conclusion of law, and opinion are vacated, set aside, and withdrawn, and amended findings, as special findings of fact, and conclusion of law entering judgment for plaintiff, with opinion, are this day filed.

11 IV. *Special findings of fact, conclusion of law, and opinion of the court, by Graham, J.*

November 9, 1925

This case was originally submitted upon an agreed statement of facts, the stipulation in that regard being signed on behalf of plaintiff by his attorneys and on behalf of defendant by Assistant Attorney General Herman J. Galloway, and upon a supplemental agreed statement of facts filed June 9, 1925, and upon such agreed statements of facts the court makes the following

Special findings of fact

I

Plaintiff is a citizen of the United States and a resident of the city of Parkersburg, county of Wood, State of West Virginia, and

has not in any way aided, abetted, or given encouragement to rebellion against the United States, or at any time aided or abetted in any manner, or given comfort to, any sovereign or government that is or ever has been at war with the United States.

II

Plaintiff on or about March 23, 1918, filed his income and excess-profits tax returns for the taxable year ending December 31, 1917. In said income-tax return plaintiff's net taxable income was stated to be $30,594.33. True copies of said income and excess-profits tax returns are annexed to plaintiff's petition as Exhibits C and D, respectively, and made a part of this finding by reference.

III

On or about June 1, 1918, there were assessed against plaintiff upon his net taxable income shown in said income-tax return income taxes in the sum of $2,110.15, which plaintiff duly paid to the collector of internal revenue for the district of Oklahoma on or about June 15, 1918.

IV

In determining his net taxable income reported in said returns plaintiff deducted $7,621.33 as a loss alleged by plaintiff to have been sustained by him upon his sale in February, 1917, of cer-
12 tain oil lands, leases, and property, to wit, the fee to Goodman farm, a lease to Matney farm, a lease to Wolfe farm, a lease to Billingslea farm, the fee to Pitman farm, and one-third interest in Helphrey oil-drilling rig.

All of said lands and property were located in the county of Tulsa, State of Oklahoma.

The fee to said Goodman farm and said Matney lease were purchased by plaintiff in 1911 at an aggregate price of $20,000, and had on March 1, 1913, an aggregate fair market value, with physical equipment, of $47,500, of which $39,500 was the value of oil reserves and $8,000 the value of the physical equipment. Subsequent to March 1, 1913, there were added by plaintiff to said Goodman farm equipment and improvements at a cost of $6,000.

Said Wolfe lease was purchased by plaintiff in July, 1913, for $26,500, of which $17,500 was paid for oil reserves and $9,000 for physical equipment, and thereafter equipment and improvements were added thereto by plaintiff at a cost of $1,794.

Said Billingslea lease was purchased by plaintiff in December, 1913, for $11,000, of which $5,000 was the value of the oil reserves and $6,000 the value of the physical equipment.

The Pitman fee was purchased by plaintiff in February, 1915, for $3,000, and was sold by him in 1917, for $4,500, a gain of $1,500.

The one-third interest in Helphrey oil-drilling rig was purchased by plaintiff in 1916 for \$183.33 and sold by him in February, 1917, for \$200, a gain of \$16.67.

The Goodman fee, Matney lease, Wolfe lease, and Billingslea lease were sold by plaintiff in February, 1917, for an aggregate price of \$76,500. This price was based on the daily production of the four properties, namely, 51 barrels, valuing the properties at \$1,500 for each barrel of oil produced daily. The daily production of each of the four properties at the time of sale was as follows:

The Goodman fee, 21.5 barrels; Matney lease, 9.6 barrels; Wolfe lease, 12.5 barrels; and Billingslea lease, 7.4 barrels.

The proportion of the total sales price allocable to the Goodman fee and Matney lease was \$46,650. As this was in excess of the cost of these properties but less than their fair market value as of March 1, 1913, there was neither gain nor loss on the sale of these two properties.

The proportion of the total sales price of \$76,500 allocable to the sale of the Wolfe lease, the Billingslea lease, and their equipment was \$29,850.

As the Wolfe and Billingslea leases and their equipment cost the plaintiff \$39,294, these properties were sold at a loss of \$9,444.

On the sale of all the properties there was a loss of \$7,927.33. Considering this loss, the correct taxable net income of plaintiff for 1917 was \$30,288.33, and the correct tax due thereon was \$2,073.36. The total tax paid by plaintiff for 1917 was \$12,966.81, of which \$2,110.15 (an overpayment of \$36.79) was paid on June 15, 1918, and \$10,856.66 was paid on November 9, 1923. The difference between the total tax paid by plaintiff for 1917, namely, \$12,966.81, and the tax due on the basis of the above computation, namely, \$2,073.36, is \$10,893.45.

The parties stipulated that the amount of the judgment herein, on the basis of the court's conclusion herein, should be \$10,893.45,
13 with interest on \$36.79 from June 15, 1918, and interest on \$10,856.66 from November 9, 1923.

V

Between March 1, 1913, and the date of said sales in February, 1917, depletion was sustained upon said properties in the sum of \$32,253.81 and depreciation in the sum of \$10,465.16, according to the method of computation employed by the Bureau of Internal Revenue.

The Commissioner of Internal Revenue allowed plaintiff deductions from his income-tax returns for the years 1913, 1914, 1915, and 1916 on account of depletion and depreciation on said properties in the amounts authorized by law and claimed by plaintiff on said returns, in the aggregate sum of \$5,156.

VI

By letter dated January 16, 1923, a true copy of which is annexed to plaintiff's petition as Exhibit E, and made a part of this finding by reference, the Commissioner of Internal Revenue notified plaintiff that an additional assessment of income and excess-profits taxes amounting to $10,856.66 would be listed against plaintiff for the taxable year ending December 31, 1917. Thereafter the said sum of $10,856.66 was duly assessed against the plaintiff, the plaintiff having executed a waiver of the limitations upon assessment.

VII

On November 5, 1923, the collector of internal revenue for the district of Oklahoma made demand upon plaintiff for the payment of said $10,856.66 additional income and excess-profits taxes for the year 1917, determined and assessed as aforesaid.

VIII

On November 9, 1923, plaintiff, under threat of said collector of penalties if plaintiff failed to make such payment and in the belief that such threat would be carried out, paid to the said collector at Oklahoma City, Okla., the sum of $10,856.66. At the time of payment plaintiff filed with the said collector a written protest against said additional assessment and against the enforced payment thereof. A true copy of said protest is annexed to the petition herein as Exhibit A, and is by reference made a part of this finding.

IX

On November 12, 1923, plaintiff duly filed with the Treasury Department, through said collector of internal revenue, a claim for refund of $10,856.66, or such greater amount as was legally refundable. A true copy of said claim for refund is annexed to the petition herein as Exhibit B, and is by reference made a part of this finding.

X

On March 20, 1924, said claim for refund was disallowed and rejected by the Commissioner of Internal Revenue.

14 XI

The taxes, refund of which was so claimed, disallowed, and rejected and which are sought in this action to be recovered, were paid without protest in the amount of $858.79 on plaintiff's original return, and under protest in the amount of $10,856.66 by reason of

the additional assessment aforesaid and resulted from the rejection and disallowance by the Commissioner of Internal Revenue of a deduction of $14,777.33 claimed by plaintiff as a loss sustained by him on the sales of said oil lands, leases, and property and from the finding by the Commissioner of Internal Revenue that plaintiff sustained no loss, but derived a profit of $26,904.15 from said sales.

Conclusion of law

Upon the foregoing special findings of fact, which are made a part of this judgment, the court decides, as a conclusion of law, that the plaintiff is entitled to recover the sum of $10,893.45, with interest on $36.79 from June 15, 1918, to November 9, 1925, amounting to $16.33 (Finding IV), and on $10,856.66 from November 9, 1923, to November 9, 1925, amounting to $1,302.80, a total of $12,212.58.

It is therefore adjudged and ordered that the plaintiff recover of and from the United States the sum of twelve thousand two hundred and twelve dollars and fifty-eight cents ($12,212.58).

Opinion

Graham, Judge, delivered the opinion of the court:

This case comes on to be heard on the joint motion of the attorneys for plaintiff and defendant to amend the findings of fact heretofore made, and a stipulation of additional facts has been filed by said attorneys with the motion to amend.

The case as originally heard was on a stipulation of facts. The court concluded that the plaintiff was entitled to recover in some amount, but was unable to determine from the facts then stipulated what the amount should be, and entered an order remanding the case for a stipulation or evidence as to the amount of the judgment that should be rendered for the plaintiff under the conclusion reached by the court.

This is a suit to recover amounts paid as taxes on income claimed to have been illegally assessed. The plaintiff prior to the year 1917 owned certain oil rights held in fee and by leases, in the operation of which he had been taking out oil. During the said year he sold these rights, some of which had been purchased prior to March 1, 1913, and the others thereafter. In his income-tax return for the year 1917 plaintiff made a deduction from his income for that year for a loss claimed to have been sustained in the sale of these oil rights. The Commissioner of Internal Revenue assessed him on the basis of this return in the amount of $2,110.15, which he paid on June 15, 1918. Thereafter the commissioner notified him of an additional assessment of $10,856.66, which the plaintiff paid under protest on November 9, 1923; and after demand for refund and compliance with the requirements of the statute he brought this suit to recover the said sum of $10,856.66, with interest from

15 November 9, 1923, as well as an additional sum of $858.79, with interest from June 15, 1918, a total sum of $11,718.45.

The claim for recovery of the said sum of $858.79 was based upon an alleged error in the first return of June 15, 1918, due to making too small a deduction for the loss sustained in the sale of the oil rights. The second assessment of $10,856.66 grew out of the following facts: The plaintiff had extracted oil from said properties (from which of them it does not appear) between March 1, 1913, and the date of the sale in February, 1917, on account of which depletion had been sustained in the sum of $32,253.81 and depreciation in the sum of $10,469.16. In his income-tax returns for the years 1913, 1914, 1915, and 1916 the plaintiff had returned the output for each of these years, and deductions, as specially provided by statute, had been allowed him on account of the depletion and depreciation of his properties. The sum named in the second assessment for depletion was based upon the amount of oil which had been taken out and sold by plaintiff after March 1, 1913; the amount for depreciation was the estimated wear and tear on the properties. These sums aggregated $42,718.97, which the Commissioner of Internal Revenue, in making the reassessment, subtracted from the cost price of the properties, and he deducted the remainder thus found from the selling price, which showed an alleged gain of $27,941.64 on the sale of the properties as against the cost price. This alleged gain was added to plaintiff's net income as stated in his first return and the reassessment based upon the sum found by this addition. If the addition of this sum to the net income was not legal, then plaintiff has been illegally assessed for taxes to that extent. This takes us back to the deduction of $42,718.97 from the cost price for depletion and depreciation.

As stated above, the claim for depletion was based upon the amount of oil taken out of the properties and sold after March 1, 1913; the sum for depreciation was the estimated wear and tear on the properties. We will consider first the question of depletion.

Some confusion has arisen in the case owing to an erroneous view of the character of the property rights of the plaintiff. These were oil rights. By them plaintiff secured the right to extract oil from these different pieces of land. The amount of oil which each contained was not known to the plaintiff or anyone. He had a mere right to extract whatever oil he could, be that amount small or great. He might take a certain amount out and then dispose of the property, but when he sold these rights he sold the same thing that he bought—a mere right to extract oil. He took the chance, in the purchase of the rights and in his expenditures for equipment and operation, of securing oil, either much or little. Whether after taking some out he had taken all did not alter the situation. A person who bought from him might by different drilling or drilling in a different place get a much larger quantity of oil than he had gotten—all dependent upon oil being found in place. The plaintiff did not purchase a certain number of barrels of oil stored in the earth; he

purchased a mere right to explore and bring to the surface and into his possession whatever oil he could find. This right was what he sold. It might have been actually more valuable or less valuable when he sold it than at the time of purchase. Whether there was oil in place beneath the surface which could be reduced to posses-
16 sion was something that could not be known or determined,
and was dependent upon what movement the oil made from time to time under the surface.

The courts have decided that a person acquiring rights of this character does not acquire ownership of oil in place, and only owns it after he has reduced it to possession. He simply has a right to reduce to possession whatever oil he might find within the limits of the property. Ohio Oil Co. v. Indiana, 177 U. S. 190. Oil is transitory, with a tendency to disappear, it being there to-day and gone to-morrow. The fact that some oil has been extracted from the property does not affect the character of the right.

Oil has no fixed situs under a particular portion of the earth's surface within a given area. It has the power of self-transmission. It belongs to the owner of the land so long, and only so long, as it remains on it and subject to his control. It has been likened to animals ferae naturae, in that it has the power and tendency to escape without the volition of the owner, so that its existence within the limits of a particular tract is uncertain by reason of its fugitive and wandering tendency. It therefore follows that the property of the owner in oil rights is limited to the mere right to explore and attempt to reduce the oil to possession, and is not absolute until the oil is actually within his grasp and brought to the surface. Ohio Oil Co. v. Indiana, supra.

The claim by the Government of the right in fixing the net income of the plaintiff for taxation to deduct from the cost price of the property the amount of oil extracted is based upon a misconception of the character of this oil after it was extracted from the earth and reduced to possession. It went upon the theory that oil extracted was a part of the capital value of the property. It was, however, income and not capital return. Stratton's Independence, Ltd., v. Howbert, 231 U. S. 399. The defendant is attempting to tax it as a part of the capital return from the sale of this property. The current profits or income from business from year to year are to be accounted for in another form and do not enter into the capital return of the property, as contemplated by the statute, in arriving at a gain or loss by purchase and sale.

To remove the oil did not deplete the capital. For the foregoing reasons, the value of the oil taken out should not have been deducted from the original cost of the property in arriving at a gain or loss by the sale.

There is still to be considered the deduction made by the Government from the purchase price on account of depreciation. This depreciation was covered in the sale price. To deduct it from the cost or add it to the purchase price is equivalent to saying that,

while the sale price was $81,200, in fact it must be fancifully fixed at $91,200, and that, while $81,200 was the actual price received, it must be taken to have been $91,200. This depreciation was a part of the necessary wear and tear incident to the use of the property. It was an expense and incident to the business. To add it to the sale price or deduct it from the cost price is in effect to say that the property must be held to have remained in the same condition after use for a number of years that it was in at the time of purchase.

17 It follows that the Commissioner of Internal Revenue was also in error in deducting from the cost of the property the above amount for depreciation.

The parties in compliance with the order of the court remanding the case filed a supplemental stipulation containing some new facts, and stipulated that the amount of the judgment to be entered for the plaintiff, within the conclusion of the court as amended in this opinion, should be $10,893.45, with interest on $36.79 from June 15, 1918, and on $10,856.66 from November 9, 1923. It therefore becomes necessary to briefly discuss the facts, but before doing so some of the legal aspects of the case should be considered.

The sections of the revenue act of 1918, dealing with the questions propounded, are:

"SEC. 202 (a). That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

"(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

"(2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203" (40 Stat. 1060).

"SEC. 213. That for the purpose of this title * * * the term 'gross income'—

"(a) Includes gains, profits, and income derived from * * * trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (40 Stat. 1065.)

In the case of Goodrich v. Edwards, 255 U. S. 527, the court held that the provisions of the act of September 8, 1916 (c. 463, 39 Stat. 756), as to taxable gain were in effect the same as those of the act of February 24, 1919 (c. 18, Title II, 40 Stat. 1057), and in United States v. Flannery, 268 U. S. 98, it was held that the provisions of the latter act "in reference to the gains derived and the losses sustained from the sale of property acquired before March 1, 1913, were correlative, and that whatever effect was intended to be given to the market value of property on that date in determining taxable gains,

a corresponding effect was intended to be given to such market value in determining deductible losses."

There are two decisions of the Supreme Court bearing upon the question before us, namely, Goodrich v. Edwards, supra, which was decided on March 28, 1921, and involved the provisions of the said act of 1916, supra, and the case of United States v. Flannery, ante, decided on April 13, 1925, and involving the said revenue act of 1918.

In the Goodrich case there were two transactions involved. The first had to do with certain shares of stock for which plaintiff paid \$500. The market value of the stock on March 1, 1913, was \$695, and he sold it in 1916 for \$13,931.22. In the second case he purchased stock for \$291,600, the value of which on March 1, 1913, was \$148,635.50, and sold it in 1916 for \$269,346.25. In the first of these transactions the court held that there was a taxable gain which was to be measured by the difference between the value of the
18 property as of March 1, 1913, and the sale price. In the second, where the selling price was greater than the value of the property on March 1, 1913, but less than the cost thereof, there was no taxable gain or allowable loss. The decision of the lower court had been in favor of the Government in both of these transactions, holding that in the first the taxable gain was the difference between the value as of March 1, 1913, and the selling price, as the selling price showed a gain over the cost, and this was affirmed by the Supreme Court. In the second transaction the lower court held that the difference between the value as of March 1, 1913, and the selling price was a taxable gain. The Supreme Court, however, said this was error, as the difference between the cost price and the selling price showed no actual gain, and that as to this transaction there was neither gain nor loss. After the Goodrich case had been tried in the lower court and decided in favor of the Government, the Solicitor General, when the case came up for hearing in the Supreme Court, confessed error as to the judgment of the lower court in the second transaction, and the case was reversed as to this.

It appears in the opinion in the Flannery case, supra, that following the decision of the Supreme Court in the Goodrich case the Bureau of Internal Revenue revised its regulations and promulgated the following:

"ARTICLE 1561. BASIS FOR DETERMINING GAIN OR LOSS FROM SALE.—For the purpose of ascertaining the gain or loss from the sale or exchange of property the basis is the cost of such property, or if acquired on or after March 1, 1913, its cost or its approved inventory value. But in the case of property acquired before March 1, 1913, when its fair market value as of that date is in excess of its cost, the gain which is taxable is the excess of the amount realized therefor over such fair market value. Also in the case of property acquired before March 1, 1913, when its fair market value as of that date is lower than its cost, the deductible loss is the excess of such fair market value over the amount realized therefor. No gain or

loss is recognized in the case of property sold or exchanged (a) at more than cost but at less than its fair market value as of March 1, 1913, or (b) at less than cost but at more than its fair market value as of March 1, 1913. * * *."

This regulation contains provisions covering the following circumstances:

"(a) Taxable gain resulted if the selling price was higher than the value on March 1, 1913, and if that value was higher than the cost thereof, to the extent that the selling price exceeded the value on March 1, 1913;

"(b) No taxable gain or allowable loss resulted if the selling price was greater than the value of the property on March 1, 1913, but less than the cost thereof;

"(c) An allowable loss resulted if the selling price was less than the value on March 1, 1913, and if that value was less than the cost to the extent of the difference between the value on March 1, 1913, and the selling price;

"(d) No taxable gain or deductible loss resulted if the selling price was less than the value thereof on March 1, 1913, but greater than the cost."

19 This regulation of the Bureau of Internal Revenue is approved in the opinion of the Supreme Court in the Flannery case.

In the Flannery case the purchase price was less than $95,175; the value as of March 1, 1913, was $116,325, and the sale price was $95,175. The court held that there was neither taxable gain nor deductible loss, thus bringing the case under the above provision (d) of the regulation of the Bureau of Internal Revenue.

We now come to the case under consideration. The court has found that as to two of the properties involved, namely, the Goodman and Matney properties, which were purchased prior to March 1, 1913, the cost thereof was $20,000; the value as of March 1, 1913, was $47,500, and the selling price, $46,650. Thus the case presents the same question as to gain and loss as in the Flannery case, and, like it, comes within the provision of said regulation of the Bureau of Internal Revenue indicated as (d) in the foregoing analysis of that regulation. As to these properties, therefore, there was neither a gain nor a loss. As to the properties purchased subsequent to March 1, 1913, the facts found show that there was a loss of $7,927.33, and that, considering this loss, the correct taxable net income of the plaintiff for the year 1917 was $30,288.33 and the correct amount of tax due thereon, $2,073.36. The tax paid by plaintiff on June 15, 1918, for the year 1917 on the first assessment was $2,110.15 and on the second assessment, $10,856.66, paid on November 17, 1923, a total of $12,966.81, leaving a balance due the plaintiff of $10,893.45, with interest on $36.79 from June 15, 1918, to November 9, 1925, amounting to $16.33 (Finding IV), and on $10,856.66 from November 9, 1923, to November 9, 1925, amounting to $1,302.80, making a total for which judgment should be rendered of $12,212.58. The sum of

$36.79, for which interest is allowed above, is the difference between the first assessment ($2,110.15) paid by plaintiff and the amount which has been found to be correctly due ($2,073.36). Judgment should therefore be entered in favor of plaintiff in the sum of $12,212.58, and it is so ordered.

Hay, Judge; Downey, Judge; Booth, Judge; and Campbell, Chief Justice, concur.

20 V. *Judgment*

Nov. 9, 1925

At a Court of Claims held in the city of Washington on the 9th day of November, A. D. 1925, judgment was ordered to be entered as follows:

The court, upon due consideration of the premises, find in favor of the plaintiff, and do order and adjudge that the plaintiff, as aforesaid, shall have and recover of and from the United States the sum of twelve thousand two hundred and twelve dollars and fifty-eight cents ($12,212.58).

By the Court.

21 [Clerk's certificate to foregoing papers omitted in printing.]

[Indorsed on cover:] File No. 31676. Court of Claims. Term No. 953. The United States, petitioner, vs. Charles A. Ludey. Petition for a writ of certiorari and exhibit thereto. Filed February 4, 1926. File No. 31676.

Supreme Court of the United States

Order allowing certiorari

Filed April 19, 1926

The petition herein for a writ of certiorari to the Court of Claims is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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AUTHORITIES CITED

In the Supreme Court of the United States

October Term, 1925

No 953

The United States, petitioner

v.

Charles A. Ludey

BRIEF IN SUPPORT OF PETITION BY THE UNITED STATES FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

OPINION OF THE COURT OF CLAIMS

The opinion in this case has not yet been officially reported. The case was decided by the Court of Claims November 9, 1925, and the opinion of the court appears at pages 14 to 20 of the printed record.

JURISDICTION

Judgment of the Court of Claims was rendered November 9, 1925. (R. 20.) Petition for certiorari was filed February 4, 1926. (R. 20.) Jurisdiction to issue the writ is conferred upon the Court by Section 3 (b) of the Act of February 13, 1925 (chap. 229, 43 Stat. 936, 939).

THE QUESTION INVOLVED

In determining gain or loss of the owner or lessee upon the sale of capital assets under the tax laws, should depletion sustained or previously allowed for oil extracted and/or depreciation sustained or previously allowed be subtracted from the cost price in determining gain or loss upon sale in 1917?

STATEMENT OF THE CASE

This suit was to recover taxes paid under protest, and claimed to have been illegally assessed, and claim for refund of which had been denied. (R. 5-7.)

The findings of the Court of Claims show that respondent, Charles A. Ludey, filed a return of his income for the calendar year 1917. (R. 11.) In this return he claimed as a deduction from gross income an alleged loss upon the sale of certain oil properties, some of which were acquired before and some after March 1, 1913. (R. 11, 12.) The respondent contended in his petition in the court below that the loss was more than that claimed in his return, namely, $14,777.33. (R. 6.) The Commissioner of Internal Revenue found that respondent derived a taxable profit of $26,904.15 on such sales. (R. 14.)

The sale out of which the commissioner held that a gain arose was of certain oil property designated in the pleadings (R. 5, 6) as:

(1) The Goodman fee and Matney lease,

(2) The Wolfe lease,

(3) The Billingslea lease,

(4) The Pitman fee, and

(5) The Helphrey oil drilling rig.

Item No. 1, the Goodman fee and the Matney lease were purchased prior to March 1, 1913, at $20,000. They were worth on March 1, 1913, $47,500, and between March 1, 1913, and the date of sale, equipment and improvements had been added at a cost of $6,000. The remaining property, items Nos. 2, 3, 4, and 5 were acquired after March 1, 1913, at a total cost, including subsequent improvements, of $42,477.33. The entire property was sold in 1917 for $81,200. Between March 1, 1913, and the date of sale these properties had been operated by the respondent and certain oil had been extracted. (R. 11, 12.) The value of the oil thus extracted was $32,253.81. During the same period the equipment had been used by the respondent and had depreciated by wear and tear to the extent of $10,465.16. (R. 12.) In calculating the gain derived from this transaction the Commissioner of Internal Revenue determined that the decrease by reason of the depletion of the oil reserves and the depreciation from wear and tear should be deducted from the cost of the property sold before determining whether there was a gain. (R. 12.) The respondent in arriving at a loss from this transaction deducts nothing for the depletion of the oil reserves and nothing for the wear and tear of the equipment. (R. 8.)

The Court of Claims held that the Government's depletion and depreciation adjustments on sale of property in 1917 were erroneous.

THE STATUTES

Title I, Act of September 8, 1916 (chap. 463, 39 Stat. 756), as amended by the Act of October 3, 1917 (chap. 63, 40 Stat. 300, 329), provides:

> SEC. 1. (a) That there shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income * * *.
>
> (b) In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax) there shall be levied, assessed, collected, and paid upon the total net income of every individual, or, in the case of a nonresident alien, the total net income received from all sources within the United States, an additional income tax (herein referred to as the additional tax) of one per centum per annum upon the amount by which such total net income exceeds $20,000 and does not exceed $40,000 * * *.
>
> (c) The foregoing normal and additional tax rates shall apply to the entire net income, except as hereinafter provided, received by every taxable person in the calendar year nineteen hundred and sixteen and in each calendar year thereafter.

SEC. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever * * *.

* * * * *

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

SEC. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

* * * * *

Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or

other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: *Provided,* That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom * * *.

SEC. 1. WAR INCOME TAX (chap. 63, 40 Stat. 300).—That in addition to the normal tax imposed by subdivision (a) of section one of the Act entitled "An Act to increase the revenue, and for other purposes," approved September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like normal tax of two per centum upon the income of every individual, a citizen or resident of the United States, received in the calendar year nineteen hundred and seventeen and every calendar year thereafter.

SEC. 2. WAR INCOME TAX.—That in addition to the additional tax imposed by subdivision (b) of section one of such Act of September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like additional tax upon the in-

> come of every individual received in the calendar year nineteen hundred and seventeen and every calendar year thereafter, as follows:
>
> One per centum per annum upon the amount by which the total net income exceeds $5,000 and does not exceed $7,500 * * *.

Title II, Act of October 3, 1917 (chap. 63, 40 Stat. 303), provides:

> SEC. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:
>
> Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year * * *.

ARGUMENT

I

THE SALE OF THE CAPITAL ASSETS HEREIN DID NOT RESULT IN AN ACTUAL LOSS DEDUCTIBLE FROM GROSS INCOME FOR THE PURPOSE OF DETERMINING NET INCOME UNDER THE PROVISIONS OF THE REVENUE ACT OF 1916 AS AMENDED

The first question presented by the decision of the Court of Claims is whether the sale of certain

capital assets resulted in an *actual* loss deductible from gross income for the purpose of determining net income under the provisions of the Revenue Act of 1916 as amended.

That statute permits the deduction of " losses actually sustained during the year, incurred in his business or trade * * *." The loss allowed by the Court of Claims arose out of the following transaction. On March 1, 1913, the taxpayer had a capital asset consisting of the Goodman Fee and the Matney Lease and the physical equipment thereon worth $47,500. Thereafter he acquired certain other properties and made certain improvements at a total cost of $48,477.33. By this outlay he acquired a right which the court below describes as " a mere right to extract whatever oil he could, be that amount small or great." During the period of his ownership, the taxpayer exercised his right and removed oil which, in the ground, had a value of $32,253.81. During the year 1917, he sold the properties for $81,400.00. The total outlay therefore was $95,977.33 as against total receipts of $113,653.81. It is plain that this transaction did not cause the taxpayer any *actual* loss. To demonstrate this, it is only necessary to assume that, instead of taking a *part* of the available oil, the taxpayer had taken it *all,* and had then sold the properties for a nominal sum. It could not be contended that, under such circumstances, the mere fact that the price obtained was less than the price

paid, showed that the taxpayer had *actually* sustained a loss.

II

A TAXABLE GAIN RESULTED HEREIN BY THE SALE OF THE CAPITAL ASSETS

The second question involved is whether there is a taxable gain. In determining the gain, the Commissioner of Internal Revenue deducted the amount of depreciation ($10,465.16) and of depletion ($32,253.81), sustained since March 1, 1913, from the cost (or value) of the properties sold, and thus ascertained that the properties sold represented a capital investment of $53,258.36 at the time of the sale. The difference between this amount and the sale price ($81,200.00), being the increase in the value of the assets sold, and thus gain realized, was included in the taxpayer's gross income.

It is clear that in the operation of an oil property, the whole gain is derived from the removal and sale of oil and the increment in the value of the oil remaining in the ground or in the right to remove it. This increment depends upon factors collateral to the right, among others the demand for oil. As this demand increases, the value of the right increases. Consequently, when it becomes necessary to ascertain whether or not a gain has been derived from the sale of an oil property, it is necessary to ascertain what, if any, increment in value is included in the sale price. This increment

is reflected in the price per barrel of daily production, upon which basis oil properties are bought and sold. For example, if a well producing ten barrels is bought in 1913, its price might be $10,000.00, which is another way of saying that that property is expected to produce ten barrels of oil per day for one thousand days, oil being worth "in the ground" one dollar per barrel. If this property later is sold at $1,500.00 per barrel of daily production, and if the daily poduction is still ten barrels, then it is manifest that, since the expected productive life is shorter, the value per barrel in the ground has increased. This increase is realized when the right to remove and sell the oil is sold, and such sale results in a taxable gain. Accordingly, it is the practice, not only of the Bureau of Internal Revenue, but also of dealers in oil property, to deduct from the cost of the property, the value in the ground of the oil removed, in order to ascertain the increment in the value of the remaining oil.

The Court of Claims holds that the plaintiff sold exactly the same property which he bought, namely, the right to remove oil and that, since the oil recovered during his ownership was income and not a return of capital, no deduction from cost price should be made for the purpose of ascertaining gain. It is urged that the taxpayer has *not* sold the same right which he acquired. This is necessarily true because in the meantime the taxpayer has used that right. Whether or not this use has produced income is immaterial. The fact

that the use changed the character of the property is the material factor. The cost of the property is merely the *basis* for determining gain or loss. Further steps are necessary in such determination, one of which is the comparison of the *property sold* with the *property bought*. These properties must be identical, for it is the cost of the property sold which is the basis for determining the gain derived from the sale. If, after the property is acquired, its character has for any reason been changed, then, while it may be possible that the taxpayer is entitled to a deduction from income by reason of such change, he is not entitled to compare the cost of the unchanged property with the sale price of the changed property for the purpose of determining whether a gain has been made. The distinction is this: If the taxpayer had, without removing any oil, sold his right for a less sum than it cost him, he would have sustained a loss because the decrease in value would have been due to economic causes, such, for instance, as an error in the estimate of the oil reserve at the time the taxpayer acquired it, or a decrease in the value of the oil in the ground. But to the extent that the decrease in value is due to the removal of oil, it is not due to economic causes, but to changes, in the nature of the property acquired, after such acquisition but prior to the sale of the property.

The Court of Claims answers this contention by pointing out that the respondent did not purchase a certain number of barrels of oils stored in the earth.

The court states " he purchased a mere right to explore and bring to the surface and into his possession whatever oil he could find." Theoretically, that statement is correct, but as a practical matter, the right which was purchased was an *oil reserve* which was susceptible of approximate measurement so that at least the price which the respondent paid for the right to remove the oil was based upon the number of barrels estimated to be in the reserve. Likewise, when he sold, the price he received was based upon the number of barrels estimated to be in the reserve at the time of the sale. The respondent's theoretical right was " exhausted " by the removal of the oil. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364. So that it is quite inaccurate, as a practical matter, to say that the right which the respondent sold was the same as the right which he purchased.

III

THE EFFECT OF THE DECISION OF THE COURT OF CLAIMS IS TO PERMIT A DEDUCTION FROM THE SALE PRICE OF AN AMOUNT PREVIOUSLY DEDUCTED BY WAY OF DEPRECIATION AND DEPLETION FROM CAPITAL INVESTMENT IN PRIOR YEARS

Even if the decision of the Court of Claims is sound in regard to depletion and depreciation sustained but not allowed as a deduction in previous years, it would seem quite apparent that the cost of the properties should be reduced to the extent that depletion and depreciation were actually allowed

and deducted by the taxpayer in his previous returns. As this Court said in *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, it is entirely immaterial whether the capital expended in the production of income be returned by way of a depreciation allowance or by deducting the cost from the purchase price. Certainly the statute does not contemplate that both deductions shall be taken. *Nashville, C. & St. L. Ry. Co.* v. *United States*, 269 Fed. 351. (Certiorari denied 255 U. S. 569.) Yet to the extent that the depreciation and depletion have been allowed and deducted in prior years, the result of the decision of the Court of Claims is that the taxpayer, having deducted a part of the capital investment by way of depreciation and depletion allowances in prior years, is permitted to deduct it again from the price obtained. The findings of fact show that depletion and depreciation were deducted in the amount of $5,156.00 (R. 12) so that the loss on the sales, on this basis, was approximately $2,800.00 instead of $7,900.00.

The Court of Claims says that the depreciation was covered in the sale price. By this it is understood that the court means that the property sold brought less money because of its depreciated condition. One of the factors which entered into the sale price was the depreciation of the property. Another factor was the increment in the value of the property. In other words, the depreciated property would have been worth less at the time

that the taxpayer acquired it than was the depreciated property at the time it was sold. The value of the property new, as it was at the time it was acquired, should not be deducted from the value of the property in its condition when sold, to determine gain or loss, because, while the depreciation was "covered in the sale price," it was not "covered in the cost."

CONCLUSION

The importance of this case has been pointed out in the petition for certiorari. (R. 4.) The rule followed by the Government has been approved by the Board of Tax Appeals in the case of *Even Realty Company*, 1 B. T. A. 355. It may be added that the principle involved, namely, that in ascertaining the gain or loss from the sale or other disposition of capital assets, it is necessary to adjust the cost or March 1, 1913, value with reference to depletion and depreciation allowed and sustained, as well as with reference to improvements and betterments, has been applied by the Bureau of Internal Revenue without exception. Consequently, it would be necessary to reaudit all returns which include either a gain or a loss from the sale or other disposition of capital assets if the Court of Claims decision were followed.

In view of the reasons herein set out, it is felt that this case presents a matter of importance not only to the Government in respect to its revenues, but also to the public at large, many of whom at

some time or other report an income from the sale or other disposition of capital assets. Your petitioner therefore prays for a writ of certorari directing the Court of Claims to certify the record herein to this Court in order that the issues involved therein and the determination of the Court of Claims may be reviewed.

Respectfully submitted.

William D. Mitchell,
Solicitor General.
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March, 1926.

INDEX

CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1926

No. 289

THE UNITED STATES, PETITIONER
v.
CHARLES A. LUDEY

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION OF THE COURT BELOW

The opinion of the Court of Claims is found on Pages 14 to 20, inclusive, of the transcript. It is reported in 61 C. Cls. 126.

GROUNDS OF JURISDICTION

The judgment to be reviewed was entered by the Court of Claims on November 9, 1925. (R. 10). A petition for certiorari was filed February 4, 1926 (R. 20). It was granted by this Court April 19, 1926 (271 U. S. 651), under Section 3 (b) of the Act of February 13, 1925 (c. 229, 43 Stat. 936, 939).

THE QUESTIONS INVOLVED

This case presents three distinct questions:

1. In determining the amount of gain or loss resulting from the sale of an oil producing property, should the previous exhaustion occasioned by the extraction and sale of oil (depletion), as well as the original cost of the property, be taken into account?

2. In determining the amount of gain or loss resulting from a sale of physical assets, such as buildings and machinery, should the previous exhaustion, wear and tear occasioned by the use of such assets (depreciation), as well as the original cost, be taken into account?

3. In determining gain or loss, should a taxpayer be allowed to deduct as a part of the cost of property sold the amount which had previously been returned to him by way of an allowance for the exhaustion, wear and tear of the properties (depletion and depreciation)?

STATUTES INVOLVED

The Revenue Act of 1916 (Title I, Act of September 8, 1916, c. 463, 39 Stat. 756, 757–759), as amended by the Revenue Act of 1917 (Act of October 3, 1917, c. 63, 40 Stat. 300, 329), provides in part as follows:

> Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or

compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * *

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

Sec. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

* * * * *

Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: *Provided,* That for the purpose of ascertaining the loss sustained from

the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom * * *.

STATEMENT OF THE CASE

This suit was instituted in the Court of Claims to recover the sum of $11,715.45 with interest, Federal income and excess profits taxes alleged to have been illegally assessed and collected for the year 1917, after a claim for the refund of such taxes had been filed by the taxpayer and denied by the Commissioner. (R. 5 to 7.)

The findings of the Court of Claims show that respondent, Charles A. Ludey, filed a return of his income for the calendar year 1917. (R. 11.) In this return he claimed as a deduction from gross income an alleged loss of $7,621.33 said to arise from the sale in 1917 of certain oil properties, some of which were acquired before and some after March 1, 1913. (R. 11, 12.)

The respondent contended in his petition in the court below that the loss was $14,777.33, which is more than that claimed in his return. (R. 6.)

The Commissioner of Internal Revenue found that respondent derived a taxable profit of \$26,904.15 on such sale. (R. 14.) The Court of Claims found that there was a deductible loss of \$7,927.33. (R. 12.)

The properties sold ~~as~~ are designated (R. 5, 6) as (1) The Goodman Farm; (2) The Matney Farm; (3) The Wolfe Farm; (4) The Billingslea Farm; (5) The Pitney Farm; and (6) a one-third interest in the Helphrey Oil Drilling Rig. These properties were acquired as follows:

In 1911 the respondent purchased the Goodman Farm in fee and a lease to the Matney Farm, together with the physical equipment thereon, at an aggregate price of \$20,000. On March 1, 1913 the fair market value of the oil reserves on these farms was \$39,500, and the fair market value of the physical equipment was \$8,000, making a total fair market value of the oil reserves and equipment of \$47,500. (R. 11.) In July, 1913, the respondent purchased a lease to the Wolfe Farm and paid for the oil reserves thereon \$17,500 and for the physical equipment thereon \$9,000, a total of \$26,500. (R. 11.) In December, 1913, the respondent purchased a lease to the Billingslea Farm and paid for the oil reserves thereon \$5,000 and for the physical equipment thereon \$6,000, a total of \$11,000. (R. 11.) In February, 1915, the respondent purchased the Pitman Farm in fee for \$3,000.

After March 1, 1913, the respondent added to the Goodman Farm equipment and improvements at a

cost of $6,000 and equipment and improvements to the Wolfe Farm at a cost of $1,794. (R. 11.)

Between March 1, 1913, and February, 1917, when the properties were sold, the respondents operated them and extracted from the oil reserves certain quantities of oil which depleted the oil reserves in the sum of $32,253.81. (R. 12, Finding V.) The depletion thus sustained was not, in full, an allowable deduction from the respondent's gross income for the respective years in which it was sustained under the Revenue Acts then in force. For the years 1913, 1914, and 1915 the allowable deduction was, under the Revenue Act of 1913, five per centum of the market value of the output for the year for which the computation was made. (Revenue Act of 1913, Section II B, c. 16, 38 Stat. 114, 167; Regulations 33, Articles 141, 142, T. D. 1944, promulgated January 5, 1914; see Appendix hereto.) For the year 1916 and that portion of the year 1917 preceding the sale the respondent was entitled to deduct depletion sustained. (Revenue Act of 1916, Title I, Part I, Section 5 (a), Paragraphs Seventh and Eighth; Part II, Section 12 (a) "Second," c. 463, 39 Stat. 756, 759, 768; see Appendix hereto.) The amount of depletion allowable under the Acts from 1913 to 1917 is not shown by the Record.

Between March 1, 1913, and the date of sale in February, 1917, the physical equipment and improvements on the properties were depreciated in

the sum of $10,465.16. (R. 12.) During the years 1913, 1914, 1915, 1916, and 1917 the taxpayer was entitled under the Revenue Acts in force during the respective years to deduct from his gross income the depreciation actually sustained. (Revenue Act of 1913, Section II B (6), 38 Stat. 114, 167; Revenue Act of 1916, Title I, Part I, Section 5 (a) "Seventh," 39 Stat. 756.)

During the years in question the respondent deducted and was allowed as depletion and depreciation from his gross income on his tax return for the respective years an aggregate sum of $5,156. (R. 12.) This was less than one-half of the depreciation alone which he was entitled to deduct. The taxpayer's reason for not claiming in full the deductions to which he was entitled in the respective years for which he was entitled to them is not shown by the record. There is no finding showing to which of the properties the depreciation and depletion actually deducted and allowed applies. Nor is there any finding showing the depletion or depreciation sustained with respect to each of the properties. Such findings were not necessary to the decision of the case on the theory adopted by the Court of Claims, but are necessary if the correct theory is that the sales were separate and account should be taken of depreciation and depletion.

The taxpayer sold all of the properties in February, 1917, for a price which in the aggregate is

$81,200, and which the Court of Claims allocates to the respective properties as follows (R. 11, 12):

To the Pitman Fee	$4,500
To the Goodman Fee and Matney lease with equipment and improvements thereon	46,650
To the Wolfe lease and Billingslea lease and their equipment	29,850
To the one-third interest in the Helphrey oil-drilling rig	200

The price obtained for the Goodman fee, the Matney lease, the Wolfe lease, and the Billingslea lease was allocated on the basis of the daily production of the four properties, which is the basis on which they were sold. (R. 12.)

In determining whether or not there was a gain or loss derived from the transaction the Commissioner of Internal Revenue held that since the oil reserves bought had been decreased by reason of the extraction therefrom of a certain amount of oil the cost (or March 1, 1913, value) of which was represented in dollars and cents by $32,253.81, and that since the equipment and improvements had been changed in character by wear and tear, which change was represented in dollars and cents by $10,465.16, the cost (or March 1, 1913, value) should be decreased so as to exclude from the cost of the property sold the cost of that portion of the property which had prior to the sale been extracted or used up. He, therefore, deducted from the cost price the amount of depletion sustained, namely, $32,253.81, and the amount of depreciation sustained, namely, $10,465.16. The difference between the cost (or March 1, 1913, value) thus decreased

and the selling price obtained showed a gain which the Commissioner included in the taxpayer's taxable income. (R. 12.) On the other hand the respondent in arriving at the loss which he now claims should be deducted from his gross income as having been sustained from this transaction does not take into account the decrease of the oil reserves or the wear and tear of the equipment, and, therefore, does not deduct anything for depletion or for depreciation from the cost (or March 1, 1913, value). (R. 8.)

The computations of the Government and of the taxpayer are as follows:

	Commissioner's calculation	Taxpayer's calculation
March 1, 1913, value Goodman fee and Matney lease	$47,500.00	$47,500.00
Cost of equipment added after March 1, 1913	6,000.00	6,000.00
Cost of Wolfe lease	26,500.00	26,500.00
Cost of equipment added	1,794.00	1,794.00
Cost of Billingslea lease	11,000.00	11,000.00
Cost of Pitman fee	3,000.00	3,000.00
Cost of Helphrey oil rig	183.33	183.33
Total, value and cost	95,977.33	95,977.33
Less:		
Depletion for oil extracted by taxpayer	32,253.81	000.00
Depreciation on equipment through use	10,465.16	000.00
	42,718.97	000.00
Cost (or value of remaining property at date of sale in 1917)	53,258.36	95,977.33
Selling price in 1917	81,200.00	81,200.00
Gain	27,941.64	00,000.00
Loss	00,000.00	14,777.33

The Court of Claims does not adopt either computation, but considers the transaction as consisting of separate sales of the properties and deter-

mines the gain or loss with respect to each sale without making any adjustment for the depletion or depreciation of the property sold, and thus determines that there is a loss of $7,927.33. (R. 12.)

SPECIFICATION OF ERRORS

The Court of Claims erred in granting judgment for the respondent and in holding that in determining the gain or loss resulting from the sale of the properties involved in this case depletion and depreciation, either sustained or allowed in previous years, should be disregarded.

SUMMARY OF THE ARGUMENT

The sale of the capital assets herein did not result in an actual loss deductible from gross income for the purpose of determining net income under the provisions of the Revenue Act of 1916, as amended. The statute provides for the deduction of *actual* losses sustained. When the transaction involved in this case is considered as a whole, it is apparent that there was no actual loss.

A taxable gain resulted from a sale of capital assets owned by the taxpayer. The increment in the value of property during ownership, when realized by sale, is taxable gain. The amount of such increment can not be determined except by adjusting the cost of the property with reference to physical changes which occurred during ownership. There were physical changes in the property involved in this case, for the property is not to be

considered for tax purposes as mere legal rights, but is to be considered, as in fact it is, as oil, machinery, buildings, etc.

The physical changes thus occurring are measured by depletion and depreciation sustained. The purpose of deducting the amount of depletion, exhaustion, wear and tear sustained from the *cost price* is to fix the extent of the physical changes in the property, which is entirely distinct from the question whether the statute permits similar deductions from *gross income* for the purpose of determining taxable income.

Even if the amount of depletion, exhaustion, wear and tear sustained is not the proper index of the physical change, the amount of depletion and depreciation for which the statutes allow as deduction from gross income should be deducted from the cost, even if such allowances are not taken by the taxpayer. The statute having provided the method by which and the time when the taxpayer shall be entitled to a restoration of his capital investment, the taxpayer can not elect a different time or method.

In any event, in so far as capital has in fact been restored by previous allowances, adjustment of cost must be made unless it is held that the statute contemplates two deductions for the same item.

ARGUMENT

I

The Transaction Did Not Result in an Actual Loss, Whether any Adjustment of the Basis for Determining Gain or Loss Be Made or Not

It seems clear that the transaction here involved, originating in the purchase, continuing through the operation, and ending in the sale, did not result in an *actual* loss deductible from gross income for the purpose of determining net income under the provisions of the Revenue Act of 1916 as amended.

That statute permits the deduction of "losses actually sustained during the year, incurred in his business or trade * * *." (*McCaughn* v. *Ludington,* 268 U. S. 106; *United States* v. *Flannery,* 268 U. S. 98.)

On March 1, 1913, the taxpayer had a capital asset worth $47,500.00. Thereafter he acquired certain other properties and made certain improvements at a total cost of $48,477.33. During the period of his ownership, the taxpayer reduced to his possession and ownership oil which at the well (Art. 142, Reg. 33, T. D. 1944, Appendix) represented a cost to him of $32,253.81. (R. 12, Finding V.) In 1917, he sold what was left of the original properties for $81,200.00. The total receipts, therefore, were: oil appropriated, $32,253.81; property sold, $81,200.00; total, $113,453.81. His capital investment was $95,977.33. The result of the whole transaction

was a gain. The transaction, therefore, did not result in any *actual* loss to the taxpayer. (*Bowers v. Kerbaugh-Empire Company,* 271 U. S. 170.) To demonstrate this, it is only necessary to assume that instead of extracting a part of the available oil the taxpayer had extracted all of it, and had then sold the properties for a nominal sum. Under such circumstances, it could hardly be contended that the taxpayer has a deductible loss when in fact he has made a profit. The unreasonableness of such a contention may be illustrated by the case of a man buying a valuable lease in 1914 for $10,000; extracting and selling at a cost of $5,000 all the oil, for which $25,000 is received; then selling the lease for $5.00; and taking as a deduction against the profit from the sale of the oil the difference between the cost of the lease and the price obtained for it.

II

The Basis for Determining Gain or Loss is the Cost or March 1, 1913, Value, as the Case May Be, of the Property Sold, but this Basis Must Be Adjusted with Reference to Depletion and Depreciation

1. Introduction.

There are four theories upon which the gain or loss realized upon the sale of capital assets, which during ownership have been depreciated or depleted, can be calculated.

The first theory and that which the Government contends is correct is that the amount of depletion

or depreciation, as the case may be, which has actually been sustained by extraction and sale of oil and wear and tear on equipment shall be deducted from the cost price as representing the physical change in the character of the property during ownership to the end that the price obtained for the property at the time of sale may be compared with the cost of like property.

Adopted

The second theory is that depletion or depreciation should be deducted from the cost only to the extent that the statutes in force during the years of ownership permit such depreciation or depletion to be deducted from gross income, and this whether or not the taxpayer in fact availed himself of the privilege extended him by the statute of taking such deductions.

The third theory is that the amount of depletion or depreciation which has actually been charged against gross income in prior years should be deducted from the cost.

The fourth theory is that adopted by the Court of Claims, upon which theory there is no deduction from cost for either depreciation or depletion, whether sustained, allowable under the statutes, or actually allowed in the particular case.

In regard to depreciation, it will be noticed that there is no difference between the first and second theories mentioned above for the reason that all depreciation sustained is and has always been an allowable deduction in computing gross income. In

regard to depletion, the first and second theories to some extent overlap for the statute in effect during the years 1913, 1914, and 1915, while permitting a deduction for depletion limited the deduction so that in certain cases it might not equal the depletion actually sustained. However, as to depletion sustained after January 1, 1916, the first and second theories are identical, inasmuch as after that date all depletion sustained was actually allowable.

2. IN DETERMINING WHETHER THERE IS A GAIN OR LOSS FROM THE SALE OF A CAPITAL ASSET, THE BASIS, COST OR MARCH 1, 1913 VALUE, AS THE CASE MAY BE, SHOULD BE REDUCED BY THE AMOUNT OF DEPLETION OR DEPRECIATION SUSTAINED.

Both depletion and depreciation change the character of property. In some cases the change is so great as, manifestly, to make it unreasonable to say that the property bought is the same thing as the property sold, e. g., a lot with a new house on it bought and sold after the house has been demolished by time and use. In other cases the change is less apparent because the property has the same name before as after depletion and depreciation have been sustained, e. g., an oil lease. But in both cases the change takes place and must be recognized as having taken place when it comes to a determination of a gain or loss realized by the sale of the changed property because gain or loss is the difference between the cost (or value) of the exact property sold and the price for which it is sold.

(*a*) ***The character of an oil property is changed by the extraction of oil from the reserve.***

In the operation of an oil property, the whole gain is derived from the removal and sale of oil and the increment in the value of the oil remaining in the ground and in the right to remove it. This increment depends upon factors collateral to the right, among others, the demand for oil. As this demand increases, the value of the right increases. Consequently, when it becomes necessary to ascertain whether or not a gain has been derived from the sale of an oil property, it is necessary to ascertain what, if any, increment in value has accrued to the property sold and is included in the sale price. This increment is reflected in the price per barrel of daily production, upon which basis developed oil properties are usually bought and sold and upon which basis the properties involved in this case were in fact bought and sold. (Finding IV, R. 12.) For example, if a well producing ten barrels per day is bought in 1913, its price might be $10,000.00, which is another way of saying that that property is expected to produce ten barrels of oil per day for one thousand days, if oil is worth "in the ground" one dollar per barrel. If this property later is sold at $1,500.00 per barrel of daily production, and the daily production is nine barrels, then it is manifest that, since the expected productive life is shorter, the value per barrel "in the ground" has increased. This

increase is realized when the right to remove and sell the oil is sold, and the gain attributable to the sale of the oil reserves in this case is a realization of such increment in the value in the ground of unextracted oil because the findings do not show any new development. Manifestly this increase in the value of the unextracted oil cannot be ascertained by comparing the total cost of the oil reserve as it existed at the time of purchase with the price obtained for that part of it remaining at the time of sale.

The cost or value of the property is merely the *basis* for determining gain or loss. Further steps are necessary in such determination, one of which is the comparison of the *property sold* with the property bought. These properties must be identical, for it is the cost (or value) of the property sold which is the basis for determining the gain derived from the sale. If, after the property is acquired, its character has for any reason been changed, then, while it may be possible that the taxpayer is entitled to a deduction from income by reason of such change he is not entitled to compare the cost of the unchanged property with the selling price of the changed property for the purpose of determining whether a gain has been made. The distinction is this: If the taxpayer had, without removing any oil, sold his right for a less sum than it cost him, he would have sustained a loss because the decrease in value would have been due to economic causes, such,

for instance, as an error in the estimate of the oil reserve at the time the taxpayer acquired it, or a decrease in the value of the oil in the ground. But to the extent that the decrease in value is due to the removal of oil, it is not due to economic causes, but to changes in the nature of the property acquired which occur after such acquision but prior to the sale of the property.

The Court of Claims holds that the respondent sold exactly the same property which he bought, namely, the right to remove oil and that, since the oil recovered during his ownership was income and not a return of capital, no deduction from cost price should be made for the purpose of ascertaining gain. Assuming that the right is the substance of the purchase, although in truth it is merely the shadow, the Government urges that the taxpayer has *not* sold even the right which he acquired. This is necessarily true because in the meantime the taxpayer has used that right and converted a part of the oil to his own use. Whether or not this conversion produced income is immaterial and it is likewise immaterial that the taxpayer has not deducted or been permitted to deduct the cost of property previously sold. The material factor is that the conversion reduced the oil reserve, and thus changed the character of the property. Although this change is expressed in dollars and cents for accounting purposes, it really means that a certain number of barrels of oil have been taken from

the reserve. It signifies a change in the extent of the property. Not only is the value of the property decreased but also the extraction of oil destroys a part of the property which the taxpayer acquired when he purchased. Although oil is a fugitive, the right to take *all* is necessarily affected by taking some. The interest of the taxpayer was lessened by the removal of oil. *Lynch* v. *Alworth-Stephens Company,* 267 U. S. 364.

The Court of Claims answers this contention by pointing out that the respondent did not purchase a certain number of barrels of oil stored in the earth. The Court states "he purchased a mere right to explore and bring to the surface and into his possession whatever oil he could find." (R. 15, 16.) Theoretically, that statement is correct, but as a practical matter, the right which was purchased was an *oil reserve* which was susceptible of approximate measurement. The price which the respondent paid was based upon the number of barrels estimated to be in the reserve. Disregarding any supposed legal theory, the respondent in fact purchased an oil reserve of so many barrels. (R. 11, Finding IV.) Likewise, when he sold, the price he received was based upon the number of barrels estimated to be in the reserve at the time of the sale. It is quite inaccurate, as a practical matter, to say that the right which the respondent sold was the same as the right which he purchased. It is true that after the removal of part of the oil he had his leases and his fee. But he did not have the

oil reserve, so when he sold, he did not sell that which he bought.

(*b*) *The character of buildings, machinery, and equipment is changed by wear, tear, and exhaustion.* The Court of Claims makes no adjustment for the depreciation of buildings, machinery, and equipment because, it says, the depreciation "was covered in the sale price." (R. 16.) By this it is understood that the court means that the property sold brought less money because of its depreciated condition. One of the factors which entered into the sale price was the depreciated condition of the property. Another factor was the increment in the value of the property. This factor the court ignores. The vice of the court's ruling results from its comparing the cost of a new property, which does not "cover depreciation," with the selling price of a depreciated property. In other words, the fact that the taxpayer in this case sold a depreciated property for less than he paid for a different property furnishes no reasonable basis for making any calculation. The value of the property new, as it was at the time it was acquired, should not be deducted from the value of the property in its condition when sold to determine gain or loss, because, while the depreciation was "covered in the sale price," it was not "covered in the cost."

Buildings, machinery, and equipment are consumed in the use so that it is impossible for one to retain such property for a period of time and then

sell that which he acquired. He buys new property and sells depreciated property. This depreciation is a loss suffered during ownership, and a loss for which the income tax statutes make due allowance. It can not be offset against increment in value (*LaBelle Iron Works* v. *United States,* 256 U. S. 377), and the gain from a sale is the realization of appreciation ~~appriciation~~ in value. It represents the increase in value of the depreciated property during ownership. This principle has consistently guided the Bureau of Internal Revenue in computing gain or loss from sale. It has been sustained directly by the Board of Tax Appeals in *Appeal of Even Realty Company,* 1 B. T. A. 355, and by inference by the courts in *Philip Henrici Company* v. *Reinecke,* 3 F. (2d) 34, and *Kaufman-Straus Company* v. *Lucas,* 12 F. (2d) 774.

3. IF THE BASIS SHOULD NOT BE REDUCED BY DEPLETION AND DEPRECIATION SUSTAINED, IT SHOULD AT LEAST BE REDUCED BY DEPLETION AND DEPRECIATION ALLOWED BY THE STATUTES AS A DEDUCTION FROM GROSS INCOME.

The reason that the cost, or March 1, 1913, value is deducted from the sales price in determining gain or loss is to restore to the taxpayer his capital investment tax free.

Goodrich v. *Edwards,* 255 U. S. 527, 534.
Doyle v. *Mitchell Bros. Co.,* 247 U. S. 179.

This does not require that all the cost (or value) must be returned before there is any gain. Thus in the *Mitchell Bros. Co. case* the entire value of

all the stumpage which the taxpayer owned was not deducted, but only the value of that part which was cut and converted during the taxable year. The requirement is that the taxpayer's capital shall be kept intact.

The purpose of the rule is satisfied if the taxpayer's capital is returned to him tax free either by way of a deduction from the gross receipts from sales or by way of a deduction from gross income. (*Doyle* v. *Mitchell Bros. Co., supra.*)

Congress has adopted the latter method, and, indeed, it is more equitable and just that the taxpayer should be allowed to replace his capital as it is expended than to require him to wait until the capital asset has entirely disappeared before any recoupment is allowed. The taxpayer is, therefore, permitted to replace his capital out of his income. To the extent that the taxpayer is thus entitled to recover his capital tax free the cost of his capital asset is reduced, and there is no capital investment to be restored when the asset is sold. To hold otherwise is to permit the taxpayer to increase his capital investment without paying any tax on the increase.

The taxpayer in this case under the applicable Act was entitled to recover $10,465.16 of his capital investment by way of depreciation allowances in 1913, 1914, 1915, 1916, and 1917. During the same period he was entitled to recover some part of $32,-253.81 by way of depletion allowances. For some reason he did not claim such deductions in those

years. He does not now seek to do so. But he here says that because he did not take advantage of the right given him by statute he can recover his total capital investment from the income of a later year. Further, he delegates to himself the right to choose the year in which he shall have the benefit. In other words, he claims that he is entitled to recoup from taxable income in the year 1917 a loss, which, had he availed himself of his statutory rights, would not have been suffered.

4. THE EFFECT OF THE DECISION OF THE COURT OF CLAIMS IS TO PERMIT A DEDUCTION FROM THE SALE PRICE OF AN AMOUNT PREVIOUSLY DEDUCTED, BY WAY OF DEPRECIATION AND DEPLETION, FROM CAPITAL INVESTMENT IN PRIOR YEARS.

Even if the decision of the Court of Claims is sound in regard to depletion and depreciation sustained or allowable but not allowed as a deduction in previous years, it would seem quite apparent that the cost of the properties should be reduced to the extent that depletion and depreciation were actually allowed and deducted by the taxpayer in his previous returns. His capital has, in fact, been restored tax-free by such allowances and the statute does not contemplate such a double deduction. *Nashville, C. & St. L. Ry. Co.* v. *United States*, 269 Fed. 351 (certiorari denied 255 U. S. 569). To the extent that the depreciation and depletion have been allowed and deducted in prior years, the result of the decision of the Court of Claims is that

the taxpayer, having deducted a part of the capital investment by way of depreciation and depletion allowances in prior years, is permitted to deduct it again from the sales price and thus show a loss which never occurred. The findings of fact (R. 12, Finding V) show that depletion and depreciation were deducted in the amount of $5,156.00 (R. 12). The findings do not show to what property it applied, so that the loss or gain on the sales, on this theory, can not be determined.

As the properties were all sold in 1917, some of them together, the Commissioner did not attempt to make a separate computation for each property, but the Court of Claims did. Its method is open under the findings, since they provide information for allocating the selling price to the various properties (R. 12). The United States takes no exception to this method of treatment in this case.

CONCLUSION

The judgment of the Court of Claims should be reversed.

Respectfully submitted.

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T. L. Lewis, Jr.,
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Bureau of Internal Revenue.

April, 1927.

Appendix

Section II, B, of the Tariff Act of October 3, 1913, c. 16, 38 Stat. 114, 167, is, in part, as follows:

> That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses; second, all interest paid within the year by a taxable person on indebtedness; third, all national, State, county, school, and municipal taxes paid within the year, not including those assessed against local benefits; fourth, losses actually sustained during the year, incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise; fifth, debts due to the taxpayer actually ascertained to be worthless and charged off within the year; sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made, but no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made: * * *.

Articles 141 and 142 of Regulations 33, promulgated January 5, 1914, by T. D. 1944, construing

the provisions of the Revenue Act of 1913, read as follows:

ART. 141. The depreciation of coal, iron, oil, gas, and all other natural deposits must be based upon the actual cost of the properties containing such deposits. In no case shall the annual deduction on this account exceed 5 per cent of the gross value at the mine (well, etc.) of the output for the year for which the computation is made.

ART. 142. The term "gross value at the mine," as used in paragraphs B and G of section 2 of the act of October 3, 1913, prescribing a limit to the amount which may be deducted in the return of individuals and corporations as depreciation in the case of mines, is held to mean the market value of ore, coal, crude oil, and gas at the mine or well, where such value is established by actual sales at the mine or well; and in case the market value of the product of the mine or well is established at some place other than at the mine or well, or on the basis of the bullion or metallic value of the ore, then the gross value at the mine is held to be the value of the ore, coal, oil, or gas sold, or of the metal produced, less transportation, reduction, and smelting charges.

If the rate of 5 per cent per annum shall return to the corporation its capital investments prior to the exhaustion of the deposits, the rate on which the annual deduction for depletion of deposits is based must be lowered in accordance with the estimated number of years it will take to exhaust the estimated reserves.

In case the reserves shall be in excess of the estimates, no further deduction on account of depletion shall be made where the

capital investment has been returned to the corporation.

The Revenue Act of September 8, 1916, c. 463, 39 Stat. 756, 759, 767, contains the following provisions in reference to deductions:

> SEC. 5. *Deductions allowed in computing net income of a citizen or resident of the United States.*
>
> * * * * *
>
> Seventh. A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade.
>
> Eighth. (a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided,* That when the allowances authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. No deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate, and no deduction shall be made for any amount of expense of restoring property or making good the ex-

haustion thereof for which an allowance is or has been made.

SEC. 12. *Deductions allowed corporations, etc.*—(a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

*   *   *   *   *

Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade; (a) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided,* That when the allowance authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made * * *.

No. [redacted] 289

IN THE

Supreme Court of the United States

OCTOBER TERM 1925.

THE UNITED STATES,
Petitioner,
vs.
CHARLES A. LUDEY.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE RESPONDENT IN OPPOSITION

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INDEX.

Citations.

IN THE

SUPREME COURT OF THE UNITED STATES,

OCTOBER TERM 1925.

No. 953.

THE UNITED STATES,
Petitioner,

vs.

CHARLES A. LUDEY.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

Opinion Below.

The opinion of the Court of Claims (R., 14) has not yet been officially reported.

Jurisdiction.

The judgment to be reviewed was entered November 9, 1925 (R., 20). Jurisdiction of this Court to issue the writ is conferred by Section 3 (b) of the Act of February 13, 1925, Chap. 229, 43 Stat. 936, 939.

The Question Involved.

In determining the gain or loss of the owner or lessee upon the sale of capital assets under the tax laws, should depletion sustained or previously allowed for oil extracted and/or depreciation sustained or previously allowed be subtracted from the cost price or added to the sales price in determining gain or loss upon sale in 1917?

Statement of the Case.

The details are unimportant in the consideration of this matter on petition for writ of certiorari. The essential facts are that the Respondent purchased and sold certain leaseholds and fees to lands which contained oil. Between the date of purchase and the date of sale, these properties were operated and so-called depletion sustained. The Respondent, in calculating his net income subject to tax for the calendar year 1917, compared the cost of these properties with the sales price thereof and found that he had suffered a loss on the sale which he accordingly claimed. The Commissioner in auditing the taxpayer's return for 1917, rejected the method used by the Respondent in determining his net income and while purporting to reduce the cost by the amount of depletion and depreciation sustained, the Commissioner in reality added to the sales price the amount of the depletion and depreciation sustained, thereby fictitiously inflating the sales price. The Commissioner in this manner determined that the Respondent had made a gain on the sale, although the amount received from the sale of the properties was less than the amount he had paid for them. The Court of Claims held that the Commissioner's action in connection with these adjustments in regard to so-called depletion and depreciation on the sale of the fees and leaseholds in 1917 was erroneous.

The Statutes.

Title I, Act of September 8, 1916 (Chap. 463, 39 Stat. 56), as amended by the Act of October 3, 1917 (Chap. 3, 40 Stat. 300, 329), provides:

Sec. 1 (a) That there shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income * * *

(b) In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax), there shall be levied, assessed, collected, and paid upon total net income of every individual, or, in the case of a nonresident alien, the total net income received from all sources within the United States, an additional income tax (herein referred to as the additional tax) of one per centum per annum upon the amount by which such total net income exceeds $20,000 and does not exceed $40,000 * * *

(c) The foregoing normal and additional tax rates shall apply to the entire net income, except as hereinafter provided, received by every taxable person in the calendar year nineteen hundred and sixteen and in each calendar year thereafter.

Sec. 2 (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or

profit, or gains or profits and income derived from any source whatever * * *

* * * * * * *

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

Sec. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

* * * * * * *

Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: Provided, That *for the purpose of ascertaining the loss sustained from the sale or other disposition of property*, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom * * *

Sec. 1. War Income Tax (Chap. 63, 40 Stat. 300),—That in addition to the normal tax imposed by subdivision (a) of section one of the Act entitled "An Act to increase the revenue, and for other purposes," approved September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like normal tax of two per

centum upon the income of every individual, a citizen or resident of the United States, received in the calendar year nineteen hundred and seventeen and every calendar year thereafter.

SEC. 2. WAR INCOME TAX.—That in addition to the additional tax imposed by subdivision (b) of section one of such Act of September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like additional tax upon the income of every individual received in the calendar year nineteen hundred and seventeen and every calendar year thereafter, as follows:

One per centum per annum upon the amount by which the total net income exceeds $5,000 and does not exceed $7,500 * * *.

Title II, Act of October 3, 1917 (chap. 63, 40 Stat. 303), provides:

SEC. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:

Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year * * *.

ARGUMENT.

Issue II set forth in the Government's petition has previously been decided by this Court.

In the Government's statement of the issues, contained in the petition for writ of certiorari, the second issue is stated (R. 4) as follows:

> II. Where property is acquired prior to March 1, 1913, and the sale price is greater than the cost but less than the March 1, 1913 value, is a loss sustained under the provisions of the revenue act of 1916, as amended by the revenue act of 1917?

Why the Government imagines this issue to be involved in this case is impossible for the Respondent to comprehend, because the opinion of the Court of Claims specifically refers to and strictly follows the decision of this Court on this precise question in *Goodrich* v. *Edwards*, 255 U. S. 527, and *United States* v. *Flannery*, 268 U. S. 98 (R. 17).

The Rule for which the Government is Contending has not been Acquiesced in Generally by Taxpayers.

The Government has stated as one of the reasons for the granting of the petition, that the rule for which it is contending has been acquiesced in generally by taxpayers. This is not the fact, as is evidenced by the existence of this very suit. Here the Respondent is suing to recover taxes paid on his 1917 income. The 1917 returns were filed eight years ago. The taxpayer has been diligent in the prosecution of his rights. He has not been guilty of dilatory tactics but has, on the contrary, urgent-

ly pressed his claim. The year 1917 was the first one in which very large taxes were levied, and it has taken the Respondent eight years to obtain a hearing in the Courts on this question. It is submitted it comes in poor grace from the Government to say that this rule has long been acquiesced in by taxpayers, when by its own tardiness and delay it has prevented the litigation of the question over a period of eight years.

Does counsel for the Government have prescience denied the ordinary man? How may he say the rule has generally been acquiesced in when it has been impossible for taxpayers to have the Commissioner take his position in respect of the taxpayer's liabilities until seven years or more have elapsed from the date the taxpayer's return was filed?

The Government, after having stated the rule for which it is contending has long been acquiesced in by taxpayers, states among its reasons for granting of the petition (R. 4.)

> "An ascertainment of the amount of taxes in *other cases* dependent upon the correctness of the Government's decision is not possible * * * "

Thus, the Government contradicts itself.

The Government has not uniformly followed the rule contended for.

The Petitioner states the following as a reason why this Court should grant the petition (R., 4):

> "2. The determination of the questions involved herein vitally affects the rules followed by the Internal Revenue Bureau since the inception of income taxation. The decision of the Court of Claims is antagonistic to these rules, which have been generally acquiesced in by taxpayers. A change in the rules at this time would affect all

> years previous to the effective date of the revenue act of 1924, which makes specific provision for such cases. An ascertainment of the amount of taxes in other cases dependent upon the correctness of the Government's position is not possible, but, without question, it runs into many millions of dollars.
>
> The rule followed by the Government has been approved by the Board of Tax Appeals. (Even Realty Company, I B. T. A. 355.)"

This statement, the Respondent, belives to be unsupported in fact.

Under the Revenue Act of 1917, which is the act governing the decision of this case, the Treasury Department's Regulations did not require that so-called depletion and depreciation should be deducted from the cost, i. e., added to the sales price. Under the Revenue Act of 1918, the Treasury Department's Regulations did require that *all* so-called depletion sustained in the operation of oil properties should be deducted from the cost, whether or not the amount of such depletion sustained was allowable as a deduction in computing annual net income. Under the Revenue Act of 1921, the Treasury Department's regulations were changed again, so as to require the deduction from the cost, i. e., the addition to the sales price, of only so much of the so-called depletion as had been allowed as a deduction from income. The Revenue Act of 1924 was the first statutory enactment which required the reduction of cost by the amount of so-called depletion and depreciation previously allowed as a deduction in computing annual net income.

Thus, we have it that the rule which the Government says has been effective since the inception of income taxation, was not in force at all under the 1917 Act, was put into full force under the 1918 Act, modified under the 1921 Act and was only included in the statute in the 1924 Act.

Treasury Department Regulations 33 Revised (governing the collection of the income tax imposed by the Act of September 8, 1916, as amended by the Act of Oct. 3, 1917), Article 101, provided as follows:

> "If a corporation sells its capital assets in whole or in part, it will include in its gross income for the year in which the sale was made an amount equivalent to the excess of the sales price over the fair market price or value of such assets, as of March 1, 1913, if acquired prior to that date, or over cost if acquired subsequent to that date. * * *"

Treasury Department Regulations 45 (promulgated April 16, 1919) governing the collection of the income tax imposed by the Revenue Act of 1918 provided as follows:

> "ART. 1561. For the purpose of ascertaining the gain or loss from the sale or exchange of property the basis is (a) its fair market price or value as of March 1, 1913, if acquired prior thereto, or (b), if acquired on or after that date, its cost or its approved inventory value. In both cases proper adjustment must be made for any depreciation or depletion *sustained*. * * *" (Italics ours.)

The ruling last quoted remained in effect until February 15, 1922, when Regulations 62 (governing the collection of taxes under the Revenue Act of 1921) were promulgated. The ruling was changed to read as follows:

> "ART. 1561. For the purpose of ascertaining the gain or loss from the sale or exchange of property, the basis is the cost of such property, or in the case of property which should be included in the inventory, its latest inventory value. * * * In any case proper adjustment must be made in computing gain or loss from the exchange or sale

of property for any depreciation or depletion *sustained and allowable* as a deduction in computing net income * * *." (Italics ours.)

None of the above mentioned Revenue Acts required depletion or depreciation to be deducted from cost in determining gain or loss on a sale. However the Revenue Act of 1924 (enacted June 3, 1924) contained the following provision:

> SEC. 202. (a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized.
>
> (b) In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, *previously allowed* with respect to such property." (Italics ours.)

Thus it appears that prior to April 16, 1919, (the date of the promulgation of Reg. 45) the rulings of the Bureau of Internal Revenue *did not* require an adjustment in cost for depletion or depreciation. It further appears that the ruling in force from April 16, 1919, to February 15, 1922, required cost to be reduced by the full amount of depletion and depreciation *sustained*, even though that amount was in excess of the deduction previously allowed in determining annual net income. It also appears that the ruling in force subsequent to February 15, 1922, required cost to be reduced only by the amount of depletion and depreciation *allowable* as a deduction in computing annual net income. The first statutory requirement of an adjustment for depletion and depreciation was contained in the Revenue Act of 1924, and

that referred only to depreciation and depletion *previously allowed* as a deduction in determining annual net income.

The decision of the court below, if affirmed by this court, would only require a change in the rulings under Regulations 45 and Regulations 62, which governed the years 1918 to 1923 inclusive. The ruling under Regulations 45 admittedly was erroneous in requiring cost to be adjusted by the amount of depreciation and depletion *sustained*. The error was partially corrected in Regulations 62.

The decision of the Board of Tax Appeals in the matter of Even Realty Company had reference only to depreciation and the effect of the decision was that cost should be reduced by the amount of depreciation *allowed* as a deduction from net income. In its opinion the Board said:

> "* * * Until the manufacturer has *recovered the cost or basic value* to him of the proportionate parts of these items attributable to a unit of his product sold, he cannot properly be said to have received income upon its sale, and only the excess of the sales price realized over the sum of these items (whatever particular form they may take) is truly income. * * *" (Italics ours.)
>
> I. B. T. A. 359.

In view of the fact that in many cases the statute of limitations has barred refunds of taxes for the years prior to 1921 respondent believes that the Petitioner's statement that the affirmance of this decision will mean a loss of "many millions of dollars" to the Government is greatly exaggerated.

The Treasury Department under regulations promulgated in accordance with the Revenue Act of 1917 did not require cost to be reduced by the amount of so-called depletion or depreciation sustained in determining the gain or loss in the case of the sale of capital assets. This case arises under the Revenue Act of 1917 and under Regulations 33 (Revised) promulgated thereunder. The regulations under the Revenue Acts of 1918 and 1921 are of no relevancy in the ascertainment of taxes due under the Revenue Act of 1917. The Revenue Act of 1924 had incorporated in it a provision directing that so much of the so-called depletion or depreciation which had been allowed as a deduction, should be deducted from cost in determining the amount of gain or loss in the sale of capital assets. If this proves anything, it proves that a different rule was contemplated under the prior statutes. *U. S.* v. *Field*, 255 U. S. 257, *Smietanka* v. *First Trust & Savings Bank*, 257 U. S. 602.

So-Called Depletion is an Earning which was Taxed as such by Congress, and such Taxation was Sustained by this Court, until Congress Permitted a Deduction out of the Abundance of its Powers.

The word "depletion" as used by the Government is a misnomer. "Depletion" in mining or oil properties so far as federal income taxation is concerned does not exist as such. Discovery may outrun depletion. *Stratton's Independence* v. *Howbert*, 231 U. S. 399. This Court has found that returns from mining operations are not capital returns in whole or in part, but are income, *Stratton's Independence* v. *Howbert, supra; Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, thus following the rule laid down by the Supreme Court of Pennsylvania in the only

reported income tax case involving the operation of oil properties. *Commonwealth* v. *Ocean Oil Co.*, 59 Pa. 61. This Court has held that the removal of natural deposits is merely an incident of business and that the part of the deposits removed in this process is not depletion of the capital. The mere fact that Congress, in the abundance of its powers, permits a deduction from gross income of an amount which it denominates depletion, does not change the character of the proceeds derived from the operation of oil properties.

The Respondent Sustained an Actual Loss on the Sale of the Properties.

The Government in its brief (p. 8) states:

> "The loss allowed by the Court of Claims arose out of the following transaction. On March 1, 1913, the taxpayer had a capital asset consisting of the Goodman Fee and the Matney Lease and the physical equipment thereon worth $47,500. Thereafter he acquired certain other properties and made certain improvements at a total cost of $48,477.33. By this outlay he acquired a right which the court below describes as 'a mere right to extract whatever oil he could, be that amount small or great.' During the period of his ownership, the taxpayer exercised his right and removed oil which, in the ground, had a value of $32,253.81. During the year 1917, he sold the properties for $81,400.00. The total outlay therefore was $95,-977.33 as against total receipts of $113,653.81."

It then states

> "It is plain that this *transaction* did not *cause* the taxpayer any actual loss."

What does the Government mean by "this transaction"? If it means *the sale* of the assets, we disagree

with the conclusion that the transaction did not cause an *actual loss*. If it means the purchase of the assets, the owning and operating of them and their subsequent sale (all of these elements considered as one transaction) we submit that the Government has missed the point and gone far afield.

The Court of Claims held that there was a loss sustained *on the sale* of the properties. It did not hold that the taxpayer sustained a loss in operating the properties. If A buys an automobile for $2,000 and in the following year sells it for $50 (even assuming allowance is made for wear and tear) he sustains *a loss on the sale* notwithstanding he may have made a net profit of $5,000 by *using* the car in a taxicab business.

A loss sustained from the sale or other disposition of property is an *actual* loss and is clearly recognized as such by Sec. 5 (a) Fourth of the Statute, supra. In computing such a loss it is not proper to take into account the profit made in the use or operation of the property. Using or operating property is a distinct transaction from that of selling the property. Apparently the Government refuses to recognize the distinction.

The Government seems entirely to miss the point *that every dollar received by the Respondent from the operation of these properties (after 1913) was included in the computation of Respondent's taxes at the rates and in the manner prescribed by law for the year received.*

While owned by the Respondent the Property did not Change in Character.

On page 10 of its brief the Government urges that the taxpayer has not sold the same right which he acquired and states, "This is necessarily true because in the meantime the taxpayer has used the right." Further on it is stated (page 11), "The fact that the use changed the character of the property is the material factor."

If the Government means the property has been changed in character, we deny the truth of the statement. If the Government means the property has been changed in value, we admit that such may be true, but deny its materiality. What was purchased was the fee to lands that happened to contain oil—what was sold was exactly the same thing, no more and no less; the leases when acquired gave the lessee the right to enter and to reduce to possession whatever oil might be found within the premises—the leases when disposed of, transmitted exactly the same thing, no more and no less. Because oil had been extracted between the time of acquisition and the time of disposition changes not one whit the accuracy of the foregoing statements. Extraction of oil may or may not have affected the value of the properties, but it did not change their character, and confusion of change in *character* with change in *value* is apparently at the foundation of the Government's difficulty.

Lynch v. *Alworth Stephens Co.*, 267 U. S. 364, cited on page 12 of the Government's brief, held that the interest of a lessee of iron mining properties *lessened* from year to year. There is no change in the *character* of the fee owner's right as a result of the operation of the property and the extraction of oil.

The Decision of Court of Claims does not Permit a Double Deduction.

On page 12 of its brief the Government contends that "the effect of the decision of the Court of Claims is to permit a deduction from the sale price of an amount previously deducted by way of depreciation and depletion from capital investment in prior years."

The effect of the decision on the contrary is to prevent the Bureau of Internal Revenue from denying to the taxpayer *the deduction allowed by Congress for de-*

preciation and depletion. The Commissioner requires the taxpayer in determining gain or loss on the sale of a capital asset to reduce the cost of that asset by the amount of the depletion deduction allowed by Congress. In other words the Commissioner allows the annual deduction granted by Congress for depletion, *provided* the asset is not sold. If the asset is sold the Commissioner deprives the taxpayer of this deduction by increasing his profit or decreasing his loss by the amount previously allowed for depletion.

Doyle v. *Mitchell Bros. Co.*, 247 U. S. 179, cited on page 13 of the Government's brief arose under the corporation excise tax of 1909 and was strictly limited by the Court to the peculiar facts in that case.

In *Stratton's Independence* v. *Howbert*, *supra*, *Stanton* v. *Baltic Mining Company*, *supra*, *Von Baumbach* v. *Sargent Land Company*, 242 U. S. 503, *United States* v. *Biwabik Mining Company*, 247 U. S. 116, and *Goldfields Consolidated Mines* v. *Scott*, 247 U. S. 126, this Court held that the proceeds from mining operations did not include a return of capital, and in *Doyle* v. *Mitchell Brothers*, *supra*, this Court said (p. 188):

> "There is only a superficial analogy between this case and the case of an allowance claimed for depreciation of a mining property through the removal of minerals, since we have held that owing to the peculiar nature of mining property its partial exhaustion attributable to the removal of ores cannot be regarded as depreciation within the meaning of the act."

Congress *was not* required to make an allowance for depletion in computing taxable net income. It saw fit to do so, however, by granting a deduction in computing annual net income.

On the other hand, Congress *was* required, in computing gain on a sale of capital assets to make allowance

for the original capital investment and to distinguish that capital from the income subjected to tax. On page 185 of this Court's opinion in the *Doyle* v. *Mitchell Brothers* case, *supra*, this statement is made with reference to the term "income":

> "Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the 'gross income' received 'from all sources'; and by applying to this the authorized deductions we arrive at 'net income'. *In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.*" (Italics ours.)

COST REPRESENTS CAPITAL. DEPLETION IS NOT A RETURN OF CAPITAL.

CONCLUSION.

The decision of the Court of Claims is consistent with the decisions of this Court and in no way conflicts with the decisions of other courts.

It conforms to established legal principles.

The Court of Claims gave careful and thorough consideration to the case and rendered an unanimous decision.

Respectfully submitted,

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100 Broadway,
New York City.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1926.

No. 289

THE UNITED STATES,
Petitioner,

v.

CHARLES A. LUDEY.

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

BRIEF FOR RESPONDENT.

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Opinion of the Court Below.

The opinion of the Court of Claims is found on pages 14 to 20, Inclusive, of the transcript. It is reported in 61 C. Cls. 126.

Grounds of Jurisdiction.

The judgment to be reviewed was entered by the Court of Claims on November 9, 1925 (R. 10). A petition for certiorari was filed February 4, 1926 (R. 20). It was granted by this Court April 19, 1926 (271 U. S. 651), under Section 3 (b) of the Act of February 13, 1925 (c. 229, 43 Stat. 936, 939).

The Question Involved.

Counsel for the respondent believes the following to be a fair statement of the question here presented:

In determining the amount of gain or loss resulting from the sale of an oil producing property, should the original cost of such property be reduced in any amount (or the sales price be increased) by reason of the extraction and sale of oil, or by reason of exhaustion, wear and tear during the period of ownership; or stated differently:

Are the proceeds from mining and oil operations, after the deduction of expenses and losses, but without a deduction of so-called depletion and depreciation, income or in part a return of capital?

The Statutes.

Title I, Act of September 8, 1916 (Chap. 463, 39 Stat. 756), as amended by the Act of October 3, 1917 (Chap. 63, 40 Stat. 300, 329), provides:

> Sec. 1 (a) That there shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income * * *
>
> Sec. 2 (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, * * * or dealings in property, whether real or personal, grow-

ing out of the ownership or use of or interest in real or personal property.

* * * * * *

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

Sec. 5. * * *

(a) For the purpose of the tax there shall be allowed as deductions—

* * * * * *

Fourth. Losses actually sustained during the year, incurred in his business or trade, * * *: Provided, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

Statement of the Case.

The properties here involved are fees and leaseholds.

"The Pitman fee was purchased by plaintiff in February, 1915, for $3,000, was sold by him in 1917 for $4,500, a gain of $1,500. * * *" (R. 11, Finding IV, sixth paragraph.)

It is found as a fact by the Court, (R. 11, Finding IV, third, fourth and fifth paragraphs) that

> "The fee to said Goodman farm and said Matney lease were purchased by plaintiff in 1911 * * *.
>
> Said Wolfe lease was purchased by plaintiff in July, 1913 * * *.
>
> Said Billingslea lease was purchased by plaintiff in December, 1913 * * *.

It is also found as a fact that

> "The Goodman fee, Matney lease, Wolfe lease and Billingslea lease were sold by plaintiff in February, 1917." (R. 11, Finding IV, last paragraph, page 11, and second paragraph page 12.)

The Court therefore found that the property purchased and the property sold was identical property, fees and leaseholds.

Statements of Fact in Petitioner's Brief.

Counsel desires to correct certain inadvertent inaccuracies which appear in the petitioner's statement of the case.

On pages 4 and 5 of his brief, the petitioner concisely and accurately explains the nature of the suit, describes the property purchased and sold, and states the cost thereof to the respondent.

Exception must be taken, however, to the statement as of fact on page 6, that while the respondent held the properties in question he "operated them and extracted from the oil reserves certain quantities of oil which depleted the oil reserves in the sum of $32,253.81". The cited reference to the record (R. 12 Finding V) does not sustain the con-

clusion. The finding referred to is that "depletion was sustained upon said properties in the sum of $32,253.81 * * * *according to the method of computation employed by the Bureau of Internal Revenue.*" The distinction here made is not a quibble, but a point of importance in respondent's view of the case. It is not found as a fact, and the respondent does not admit, that there was any such depletion or decrease of oil reserves. It is found as a fact, and of course not denied, that certain oil was extracted from the properties. But manifestly, in the nature of the case, it is unknown, and impossible of human determination, how much oil was recoverable when the respondent acquired the properties or when he disposed of them and, therefore, it cannot be found or stated as a fact how much, or indeed, if any depletion was actually sustained.

A similar exception is taken to the statement on pages 6 and 7 of petitioner's brief that "the physical equipment and improvements on the properties were depreciated in the sum of $10,465.16". This figure was also found "according to the method of computation employed by the Bureau of Internal Revenue" (R. p. 12).

Throughout his statement of the facts and as well throughout the entire brief the learned Solicitor General appears to consider as established and agreed that the oil content of the properties was actually and definitely depleted and that the physical equipment and improvements actually and definitely depreciated while in the ownership of the respondent. Thus on page 12 of his brief he states, "During the period of his ownership, the taxpayer reduced to his possession and ownership oil which at the well (Art. 142, Reg. 33, T. D. 1944, Appendix) represented a cost to him of $32,253.81 (R. 12, Finding V.)". Counsel has

pointed out that nothing in the record justifies the statement that depletion was sustained and it is difficult to apprehend whether the Solicitor General is relying on Finding V for his statement or on Art. 142 of Reg. 33, T. D. 1944, which was rejected by this court in *Goldfield Consolidated Mines Company* v. *Scott*, 247 U. S., 126, insofar as depletion and depreciation was considered a return of cost or capital.

The persistence of this error calls for emphasis on its correction. Thus on page 19 of the petitioner's brief it is said:

> "Disregarding any supposed legal theory, the respondent in fact purchased an oil reserve of so many barrels. (R. 11, Finding IV.) Likewise when he sold, the price he received was based upon the number of barrels estimated to be in the reserve at the time of sale."

This statement is not supported by the finding of the court below (R. 12, Finding IV), nor is it consistent with the Solicitor General's own statement of the case on page 8 of his brief, as follows:

> "The price obtained for the Goodman fee, the Matney lease, the Wolfe lease and the Billingslea lease was allocated on the basis of the *daily production* of the four properties, *which is the basis on which they were sold* (R. 12)."

It is desired, before entering the argument, to emphasize that the respondent does not agree, but on the contrary denies, that the properties in question were actually depleted or depreciated, or in any degree changed in character, while in the ownership of the respondent.

Summary of Argument.

The respondent sold capital assets at a price less than their cost or fair market value and thereby suffered an actual loss.

The increase of taxable gain in the year of sale of a capital asset by reducing the actual cost, by such amounts as the Government deems to represent depletion or depreciation of prior years, results directly in taxing capital in the amount that actual cost exceeds the basis used by the Government.

The proceeds from mining and oil operations in excess of expenses and losses are *income* and not in part a return of capital. The law could not be otherwise, because of the nature of mining and oil properties. Discovery and development may outrun depletion. Oil has no fixed situs under a particular portion of the earth's surface. It has the power of self transmission and that which is in one's property today may move or be drawn into another's tomorrow. There is no ownership of oil until it is actually reduced to possession. The only right an owner or lessee has is the right to prospect for and reduce to possession. The exhaustion of a natural deposit may be deferred over a long term of years and may never entirely occur. It is repugnant to reason and to the facts to say that the proceeds from mining operations over expenses and losses are anything other than income. It may be true in certain cases as this court has observed, that the operation of the deposit serves to exhaust it in a measure and that the proceeds of the operation include a modicum of capital; but this court has also held that that fact is contemplated when the investment is made, the modicum of the capital that may be

included in the proceeds is not of sufficient importance to be taken into account.

The purchase of an "oil reserve" is not the purchase of a certain number of barrels of oil. The phrase, "oil reserve", properly refers to the character of the property, the right to take whatever oil may be obtained from it, and does not refer to or describe an inert body of oil of unchanged quantity except as lessened by extraction. An "oil reserve" is not a reservoir or tank of oil.

The properties purchased and sold were fees and leaseholds. These properties did not change "in character". The extraction, refining and sale of oil were not part of the transaction of purchase and sale of the fees and leaseholds. The proceeds from operation were annual gains returned and taxed according to the laws in effect during the years the proceeds were earned. After a tree has borne fruit, it is none the less a tree. And even if the property had changed in character between the dates of purchase and sale, a gain or loss would have resulted, measured by the difference between the cost and sale price.

The action of the petitioner increases the taxable gain on the sale by reducing the cost in such amounts as the government deems to represent depletion or depreciation of prior years. *Thus it directly taxes capital in the amount that cost exceeds the basis used by the Government.* Such action also in effect denies to the respondent previous annual deductions granted by Congress and mulcts him by the difference between the extremely high rates in 1917 and the very low rates in effect from 1913 to 1917.

The government proposes to read something into the statute which is not there, to graft something on it, to read it loosely instead of strictly, to tax by implication, and to resolve all doubts in favor of the government.

Clearly, the proceeds from mining operations in excess of expenses and loss are earnings,—income. In the sale of a fee or leasehold to mining properties the cost should not be reduced, thereby fictitiously increasing the gain in the year sold, by any amount received from operations.

Argument.

The United States has here taxed such part of *the proceeds realized upon the sale of an oil property* as represents the amount of so-called depletion and depreciation which it claims was theretofore sustained, contending that the respondent had by virtue of such depletion and depreciation recouped from operations a part of the capital originally invested.

The respondent submits that the increase of taxable gain in the year of sale of capital assets by reducing the actual cost in the amount of so-called depletion and depreciation of prior years results in a direct tax, a tax on capital and not on income, because the proceeds of operations denominated depletion and depreciation are not returns of capital, but are earnings as this court has held. The reduction of the cost by such amounts subjects to tax a part of the cost. Thus the question may be stated:

Are the Proceeds From Mining and Oil Operations Income or in Part a Return of Capital?

If such proceeds are income, the decision should be for the respondent, but if they are in part a return of capital, the decision should be for the petitioner.

The petitioner in its brief has begged the question. It has *assumed* as its premise that so-called depletion and depreciation are a return of capital.

This court has held otherwise and passed squarely upon the question in the case of *Goldfield Consolidated Mines Company* v. *Scott*, 247 U. S. 126. In that case the Circuit Court of Appeals for the Ninth Circuit certified these two questions for decision, page 130, as follows:

> "The questions propounded are:
>
> '1. Under the provisions of paragraph 38 of the Act of Congress * * * approved August 5th, 1909, * * * is a mining corporation, for the purpose of determining its net income for the basis of taxation, entitled to deduct from its gross income *any amount whatever** on account of depletion or exhaustion of ore bodies caused by its operations for the year for which the tax is assessed?
>
> '2. Is such a corporation under said Act, entitled in the ascertainment of its net income, to a deduction against gross proceeds from the mining and treatment of ores *to the extent of the cost value* of the ore in the ground before it was mined, ascertained in strict compliance with the rules and regulations of the Treasury Department of February 14th, 1911 (T. D. 1675)?

These questions are direct, unequivocal and unambiguous. Clearly, if such a deduction were a return of capital, such a corporation would be entitled to it. The answer of this court was likewise direct, unequivocal and unambiguous, as follows:

> "In view of the discussion of the nature of mining property in Stratton's Independence *v.* Howbert, *supra,* and the application of the principles therein laid down in the subsequent cases of Stanton v. Baltic Mining Co., 240 U. S. 103, and Von Baumbach *v.*

* (Italics, where used, are ours unless otherwise noted.)

Sargent Land Co., *supra,* it is unnecessary to enter upon further consideration of the matters disposed of in those cases. We find no occasion to depart from the principles therein announced, or the rulings therein made. They have been reaffirmed in the case of United States *v.* Biwabik Mining Co., *ante,* 116. In this view it follows that *the first and second questions must be answered in the negative,* and that it is unnecessary to answer the third and fourth questions."

This court had previously held in *Stratton's Independence* v. *Howbert,* 231 U. S. 399, that deduction for the exhaustion of the ore body did not constitute depreciation; in *Stanton* v. *Baltic Mining Company,* 240 U. S. 103, that the denial of a deduction for the exhaustion of the ore body and the taxation of the proceeds thereof was not a tax on capital; and there was no question of a loss involved. Therefore, the proceeds from mining operations can be nothing but income, and this court has so held, and *has held those proceeds taxable as income.* " 'Income' has been taken to mean the same thing as used in the Corporation Excise Tax Act of (August 5), 1909 (36 Stat. at L. 11, chap. 6), in the 16th Amendment and in the various revenue acts subsequently passed." *Bowers* v. *Kerbaugh-Empire Company, decided May 3, 1926,* 271 U. S. 518; *Southern P. Co.* v. *Lowe,* 247 U. S. 330, 335; *Merchants' Loan & T. Co.* v. *Smietanka,* 255 U. S. 509, 519.

Counsel submits that the above decisions are entirely conclusive upon the issue here presented.

Lynch v. *Alworth-Stephens Co.,* 267 U. S. 364, merely holds that the lessee of a mining property is entitled to his proportionate share of *a statutory deduction* for deple-

tion; it does not alter, but on the contrary, reaffirms, the long established rule of this court, that in determining income no allowance need be made for depletion in the absence of statutory provision therefor, and that the returns from mining properties are in fact income and not capital.

The Pennsylvania courts have passed on questions such as this one many times. Oil was first discovered in Pennsylvania and this court has always given great weight to decisions of that state on questions concerning natural resources. *Ohio Oil Co.* v. *Indiana*, 177 U. S. 190. In the case of *Commonwealth* v. *The Ocean Oil Co.*, 59 Penna. St. 61, Pennsylvania had levied a tax of 3 per centum upon *the net income* of corporations. The Ocean Oil Co. resisted the assessment contending that the proceeds from the operation of oil properties in excess of expenses were a return of capital. The lower court held that there should be a deduction for a return of capital measured by so much of the annual product as would repay the capital in the probable number of years that oil would flow or be taken from the land and that only the excess of the proceeds over expenses and the aliquot deduction for return of capital constituted "net income" subject to tax, just as the Government has done in the case at bar. The Supreme Court of Pennsylvania rejected the opinion of the lower court and held, page 63:

> "The question therefore is, what is the meaning of 'net earnings or income'? Does it mean, as it was construed by the treasurer in his report to the auditor-general, the product of the business after deducting expenses only? If so, then the settlement by the auditor-general and state treasurer is correct.

But it is contended by the company, that the annual product must first be applied to the repayment of capital, and this would leave no net earnings or income to tax. The court below compromised between these two constructions, and held that there must be an application of so much of the annual product, as would repay the capital, in the probable number of years that oil would flow or be taken from the land, and then the surplus would be the net earnings or income subject to taxation. This mode requires the interposition of a jury wherever there is a difference of opinion between the company and the state authorities.

I can see no warrant for such a reading of the law. * * * * *

See also same decision by same court on same questions where the operations were for coal. *Commonwealth* v. *The Penn Gas Coal Co.*, 62 Penna St. 241.

The decisions of the English courts and the state courts of this country are in accord with the above cited decisions, holding that a mining corporation "like any other corporation organized for the purpose of utilizing a wasting property,—a property that can be used only by consuming it,—as a mine, a lease, or a patent, is not deemed to have divided its capital merely because it has distributed the net proceeds of its mining operations, although the necessary result is that so much has been subtracted from the substance of its estate. Mor. Priv. Corp., §442, *Lee* v. *Neuchatel Asphalte Company*, 41 Ch. Div. 24." *Excelsior Water & Mining Company* v. *Pierce*, 90 Cal. 131, 27 Pac. 44; *People ex rel. United Verde Copper Company* v. *Roberts*, 156 N. Y. 585, 51 N. E. 293; *Mellon* v. *Mississippi Wire Glass Company*, 77 N. J. E. 498, 78 Atl. 710; *Van Vleet* v.

Evangeline Oil Co., 129 La. 406, 56 Southern 343; *Boothe* v. *Summit Coal Mining Co.*, 55 Wash. 167; 104 Pac. 207; and Sec. 34 of Chap. 65 of the Revised Code of Delaware as amended, Mar. 2, 1927.

The text writers are uniformly to the same effect. Morawetz Private Corporations, Section 442, page 415; Clark & Marshall on Private Corporations, Volume 2, page 1593; Thompson's Commentaries on the Law of Private Corporations, page 111; Cook on Private Corporations, Volume 2, page 1903; Encyclopedia of Law and Procedure, Volume 10, page 553 (1904); Corpus Juris, Volume 14, page 802 (1919); Fletcher's Cyc. of the Law of Private Corporations (1919), Sec. 3670, page 6104.

The Decisions Could Not Be Otherwise Because of the Nature of Mining and Oil Properties.

This court has held that oil is fugacious, has the power of self-transmission, moves from place to place, and that which is in one person's property today may move or be drawn into another's tomorrow. This being true, it may not be said that so-called depletion of the capital invested in an enterprise is effected when a certain number of barrels of oil are removed from one's property. One of the leading cases to this effect is *Brown* v. *Spilman*, 155 U. S. 665, 669, wherein this court said:

> "Petroleum gas and oil are substances of a peculiar character, and decisions in ordinary cases of mining, for coal and other minerals which have a fixed *situs*, cannot be applied to contracts concerning them without some qualifications. They belong to the owner of the land, and are part of it, so long as they are on it or in it, or subject to his control, but when they escape and go into other land, or come under

another's control, the title of the former owner is gone. If an adjoining owner drills his own land and taps a deposit of oil or gas, extending under his neighbor's field, so that it comes into his well, it becomes his property. Brown *v.* Vandergrift, 80 Penn. St. 142, 147; Westmoreland Nat. Gas Co.'s Appeal, 25 Weekly Notes of Cases, (Penn.), 103."

And the later leading cases of *Ohio Oil Company* v. *Indiana*, 177 U. S. 190; *Lindsley* v. *Natural Carbonic Gas Company*, 220 U. S. 61; *West* v. *Kansas Natural Gas Co.*, 221 U. S. 229; *Walls* v. *Midland Carbon Co.*, 254 U. S. 300; *Rich* v. *Doneghey* (Okla.) 177 Pac. 86, 89; *Lindlay* v. *Raydure*, 239 Fed. 928.

In *Ohio Oil Company* v. *Indiana*, *supra*, this court said, speaking of oil and gas, "they have no fixed *situs* under a particular portion of the earth's surface within the area where they obtain. They have the power, as it were, of self-transmission", and are analogous to things *ferae naturae*. See also *Brown* v. *Vandergrift*, 80 Penn. St. 142, 147; *Westmoreland & Cambria Natural Gas Co.* v. *Dewitt*, 130 Penn. St. 235. See also *Stratton's Independence* v. *Howbert*, *supra*.

These decisions plainly hold, which is the fact, that although oil may be extracted from beneath the surface of one's property other oil may and does come into the property from that of others, thereby taking the place of the oil theretofore extracted, and that discovery may outrun depletion.

The Respondent Did Not Purchase an "Oil Reserve" *of a Certain Number of Barrels of Oil,* as Contended by the Petitioner.

This court has repeatedly held that there is no ownership of oil in the ground or "in place."

In *Ohio Oil Company* v. *Indiana, supra,* the facts were that the State of Indiana passed a statute making it unlawful for any person to permit the flow of gas or oil from any well into the open air for a longer period than two days next after the oil was struck. The State of Indiana filed a complaint against the Ohio Oil Company, stating that it had failed to confine the oil or gas in the manner required by the statute and asked that a writ of injunction issue. The Ohio Oil Company objected that the statute caused a taking of private property without adequate compensation. The decision turned on the point whether the owners of the surface owned the oil beneath. If they did, of course the State of Indiana could not interfere; if they did not the State had the right to conserve the common property. Mr. Justice White for the court held, page 208, that:

> "Although in virtue of his proprietorship the owner of the surface may bore wells for the purpose of extracting natural gas and oil, until these substances are actually reduced by him to possession, he has no title whatever to them as owner. That is, he has the exclusive right on his own land to seek to acquire them, but they do not become his property until the effort has resulted in dominion and control by actual possession."

And on page 209, the court said further concerning the rights of the owner of the well to oil and gas, that:

> "It being true as to both animals *ferae naturae* and gas and oil, therefore, that whilst the right to

> appropriate and become the owner exists, proprietorship does not take being until the particular subjects of the right become property by being reduced to actual possession."

The same is true under the laws of Oklahoma where these properties are situated. See *Rich* v. *Doneghey, supra.*

This court has reaffirmed and reiterated its decisions thereon in every case which has come before it since then, notably in *West* v. *Kansas Natural Gas Company,* and *Walls* v. *Midland Carbon Company,* (1920), *supra.*

Under the decisions of this court, therefore, the extraction of oil from a given property does not exhaust the capital thereof or the oil therein, a certain quantity of oil was not purchased, and an "oil reserve" of a certain number of barrels of oil was not acquired. The fugacious character of the oil, the fact that the owner of the land, or the lessee, has no title to the oil until it is reduced to dominion and control—actual possession,—the fact that there may be numerous strata under the surface which render oil and may be opened from time to time, and the fact that nature is always creating oil, render wholly untenable the position of the petitioner that the respondent purchased an "oil reserve" of a certain number of barrels of oil.

The Grant by Congress of a Deduction for Depletion or Depreciation Which It Is not Required to Allow Does not Change the Character of the Proceeds From Income to Capital.

This court has held that so-called depletion is income both under the Sixteenth Amendment and under the Revenue Acts of 1909 and 1913. *Stanton* v. *Baltic and Goldfield Consolidated Mining Co.* v. *Scott, supra.* Its fundamental nature is not changed because Congress, to provide suffi-

cient rewards for the operation of an extra-hazardous enterprise, to encourage the development of new producing properties, or for any other reason, in the abundance of its powers, has granted a deduction for the purpose of determining current taxable income from operations of some, but not all, years, which deduction it was not required to grant.

It was not until the Revenue Act of 1924, (Sec. 202 (b)), was enacted that there was any legislative provision that so-called depletion or depreciation should be deducted from the cost in order to determine the gain or loss on the sale of capital assets. There had theretofore been enacted five different Revenue Acts; those of 1909, 1913, 1916, 1916 as amended by the Revenue Act of 1917, and the Revenue Act of 1918, four of which were enacted after the passage of the 16th Amendment. The Treasury Department's practice had *not* been to require the reduction of the cost price by such allowances, because there is nothing in the Treasury regulations concerning this matter until the promulgation of Regulations 45, on *April 16, 1919*, which were subsequently changed several times. It is thus perfectly clear under the decisions of this court that Congress did not contemplate the reduction of cost by amounts for depletion or depreciation under any of the Revenue Acts prior to that of 1924. *United States* v. *Field*, 255 U. S. 257; *Smietanka* v. *First Trust & Savings Bank*, 257 U. S. 602.

In the latter case this court, in disposing of the government's contention for the application of the provisions of a later act to taxes of earlier years, stated on page 606:

> "This seems to us to graft something on the statute that is not there. It is an amendment and

not a construction, and such an amendment was made in subsequent income tax laws * * *."

These decisions were followed in the case of *U. S. v. Merriam*, 263 U. S. 179, 187, wherein the court said:

> "On behalf of the Government it is urged that taxation is a practical matter and concerns itself with the substance of the thing upon which the tax is imposed rather than with legal forms or expressions. But in statutes levying taxes the literal meaning of the words employed is most important, for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer. Gould *v.* Gould, 245 U. S. 151, 153. The rule is stated by Lord Cairns in Partington *v.* Attorney-General, L. R. 4 H. L. 100, 122."

Counsel submits that to increase the taxable income in this case by any amount for so-called depletion or depreciation of earlier years would be to graft something on the statute which is clearly not there and not contemplated, that the provisions of the Revenue Acts may not be extended by reading into them a construction which is not apparent, that revenue acts are to be strictly construed and that they are not to be extended by implication. Therefore, it is clear no reduction should be made in the cost price in the case at bar.

Holmes on Federal Taxes, 1923 Edition, page 501 dealing with this precise question is to the same effect:

> "In computing the gain derived or loss sustained upon a sale or exchange of property for property (in cases in which an exchange results in recog-

nizable gain or loss) the treasury department has ruled that there should be subtracted from cost, or added to selling price (it is immaterial which is done, since in both cases the gain is increased or the loss is reduced, as the case may be), any depreciation or depletion sustained and allowable as a deduction in computing net income with respect to the property sold or exchanged. * * * This ruling is without express statutory basis; neither the Revenue Act of 1921 nor any of the previous laws specifically provided that in computing taxable gain or deductible loss there should be any adjustment for depreciation or depletion. *There is much to be said for the theory that where a statute specifically and in detail provides a basis for determining gain derived or loss sustained upon a sale or exchange of property, modifications of that basis should not be read by implication into the statute. The requirement of the department that an adjustment should be made for depreciation or depletion has the effect of nullifying the provisions of the statute permitting annual deductions for depreciation. Its result is to throw into income in one year (the year of sale or exchange) the total of the amounts deducted as depreciation or depletion in several years.*"

Holmes' last work, 1925, page 702, is to the same effect.

The Petitioner Errs in Considering the Purchase, *Operation*, and Sale as Being One Transaction. There Was an Actual Loss.

The transaction here involved is the *sale* of certain property *during the year 1917.* The question before the court is what gain or loss if any resulted from *that sale.* Therefore, we are not concerned with the profits or gains derived annually through the *operation or use* of the prop-

erty during ownership. Those profits were properly accounted for in the taxpayer's annual income tax returns for the years in which such profits were received. To illustrate with a simple case, if a taxpayer purchased an automobile in 1915 for $2,000 and sold it in 1917 for $1,000 he sustained a loss on *the sale* notwithstanding he may have made a net profit of $3,000 by *using* the car in a taxicab business during the year 1916. The profit of $3,000 was derived from an entirely separate and distinct transaction—operation or use of the car during the year 1916—and has no bearing whatsoever on the loss sustained on the sale of the car in the year 1917. The petitioner adds to the sale price part of the receipts from operation arising between the date of purchase to the date of sale. The profit derived from the *operation or use* of the property is not a factor entering into the proper determination of gain or loss on the *sale* of the property. We are not concerned with the *operation* of an oil property *i. e.*, the removal and sale of oil. What we are concerned with is the result in gain or loss arising from the sale of fees and leases. Gain may be derived from the *operation* of oil lands, but that gain is income and is of no moment here for it results from an entirely different transaction and involves other questions not material in the present issue.

The petitioner on page 13 of his brief cites the example of a man buying a "lease in 1914 for $10,000, extracting and selling at a cost of $5,000 all the oil, for which $25,000 is received; then selling the lease for $5.00; and then taking as a deduction *against the profit from the sale of the oil*" the difference between cost and sale price. This is thaumaturgy which counsel for the respondent cannot understand, unless the lease were sold in the year in which bought, and if that

is the case, the deduction for the difference between the cost and sales price was correct. If, however, the lease were sold in a year subsequent to 1914, as in the example, how could the loss be taken "against the profit from the sale of the oil" in earlier years? It could not; the profits from the sale of the oil would have been taxed annually as earned according to the statutes in effect at that time. In the instant case the respondent does not seek to offset in any manner the profit derived from the sale of oil. The respondent made his returns and paid his income taxes annually on his profits from the sale of oil. He makes no contention that those profits were overstated or excessively taxed and he seeks no adjustment in that connection. He is now concerned solely with the profit—or loss—resulting from the sale of the properties in 1917.

The property was sold for less than it cost. There was therefore a loss from the sale of property. Such loss was an actual loss and a proper deduction from income calculated in accordance with this court's opinions in the cases of *U. S.* v. *Flannery*, 268 U. S. 98; and *McCaughn* v. *Ludington*, 268 U. S. 106.

The character of the property did not change between the date of purchase and the date of sale, but even if it had changed, that would not affect the fact of gain or loss.

The parties on this point stand on fundamentally different grounds. The government's position is that both depletion and depreciation change the *character* of property. The taxpayer denies that either depletion or depreciation works any change in the *character* of property.

The parties, of course, are in agreement that gain or loss is the difference between the cost (or value) and the

sales price of a particular property, for obviously the gain or loss on the sale of one certain property cannot be determined by comparing its cost or sales price with the cost or sales price of a different property. There is no disputing that the cost of a given quantity of oil cannot be compared with the sales price of a lesser quantity of oil to determine the gain or loss on a sale of the latter; or that the cost of a lot with a new house on it cannot be compared with the sales price of the lot alone to determine gain or loss on the sale of the lot. But these illustrations in the petitioner's brief throw no light on the issue presented in the instant case, for they are not at all analogous.

We are not here dealing with a purchase and sale of a given quantity of oil or of oil in reservoirs or tanks. We are dealing with fees and leaseholds of oil producing lands (R. 11). Such property does not change in character by mere operation or use. The extraction of oil from the lands does not change the character of the fee or the lease. And ordinary wear and tear on machinery does not change the character of the machinery. The extraction of the oil (so-called depletion) and the wear and tear (so-called depreciation) may or may not result in a diminution of market value of the properties, but the nature and character of the properties remain the same.

The fees and leases purchased by the respondent gave him the exclusive right to prospect for and reduce to possession whatever oil might be found within the limits of the properties. How large or small the quantity of that oil might be was beyond the limits of human knowledge. There is no finding of fact as to the quantity of oil recoverable from the lands here in question, as indeed there could not be from the very nature of the thing. The respondent could

not have purchased an oil reserve of certain content as the petitioner suggests, because no one could know what oil, if any, might be recovered and no one could give him title to such an "oil reserve", because no one had title. The phrase, "oil reserve", properly refers to the character of the property, the right to take whatever oil may be obtained from it; it does not refer to or describe an inert body of oil of unchanging quantity except as lessened by extraction. The respondent did not purchase oil in a tank or reservoir. When the properties were purchased there may have been only 5,000 barrels under the surface, but, upon bringing in a well, 500,000 barrels may have been drawn from other properties.

There is, therefore, no foundation for the argument that the increase in the value of unextracted oil cannot be ascertained by comparing the total cost of the "oil reserve" as it existed at the time of purchase with the price obtained for that part of it remaining at the time of the sale.

The character or kind of property purchased and sold, we reiterate, consisted of fees and leaseholds. The respondent had the exclusive and unrestricted right to prospect for and reduce to possession at any and all times any oil that could be extracted from such lands. This right remained constant in character notwithstanding the removal of oil. Its value may have changed but its nature, its character, remained the same. The removal of oil worked no change in the "extent" of the property purchased. Oil was the fruit of the property and not the property itself, and the proceeds of the sale of the oil represented *gains, profits and income derived from capital* and not capital itself. As a tree bears fruit and, after the fruit is gone, remains to bear further fruit, the extent of which is unknown, so in the

present case the property bears oil and yet remains itself intact to bear further oil.

Manifestly, the receipt of income from capital does not work a change in the character of the capital; and it is contradictory to say that the receipt of income *derived* from capital constitutes a return of that capital.

The taxpayer is not now trying to recoup in the year 1917 losses of earlier years.

In the findings of fact which were stipulated by the parties (R. 12, Finding V), it is shown that the respondent deducted from his income tax returns for the year 1913, 1914, 1915 and 1916 on account of so-called depletion and depreciation the aggregate sum of $5,156, as against the aggregate sum of $43,110.47, alleged by the Commissioner of Internal Revenue to have been sustained.

The petitioner in its brief at page 22 says:

> "The taxpayer in this case under the applicable Act was entitled to recover $10,465.16 of his capital investment by way of depreciation allowances in 1913, 1914, 1915, 1916 and 1917. During the same period he was entitled to recover some part of $32,253.81 by way of depletion allowances. For some reason he did not claim such deductions in those years. He does not now seek to do so. But he here says that because he did not take advantage of the right given him by statute he can recover his total capital investment from the income of a later year. Further, he delegates to himself the right to choose the year in which he shall have the benefit. In other words, he claims that he is entitled to recoup from taxable income in the year 1917 a loss, which, had he availed himself of his statutory rights, would not have been suffered."

But on page 18 of the brief it is said it is immaterial, "that the taxpayer has not deducted or been permitted to deduct the cost of property previously sold."

Suffice it to say that the found facts are that the taxpayer respondent, who operated the properties, deemed that he had sustained depletion in the four years under consideration in an amount less than the amount which the Commissioner of Internal Revenue, according to his method of calculation, considered respondent to have suffered. It might well be urged that the respondent was more capable of determining so-called depletion and depreciation on the ground where the properties were than the Commissioner of Internal Revenue in Washington. The fact of the matter is that the respondent is not seeking, as the Solicitor General states, to recover his total capital investment from income of a later year, because no matter how the calculation is made it has abundantly been shown he suffered no capital losses by depletion and depreciation.

The decision of the Court of Claims does not permit a double deduction. The petitioner would deny a deduction granted by Congress and mulct the respondent in a year of higher rates.

The government has *assumed* that so-called depletion and depreciation are actually a return of capital. Counsel submits it has repeatedly been shown that depletion and depreciation are not a return of capital. The taxpayer's gains in each year were accounted for in the year in which earned and a tax thereon was paid in accordance with the Revenue Acts in effect at that time. The only deduction taken for all these years was the sum of $5,156.00.

The decision of the Court of Claims grants to the respondent that which Congress has clearly given him and

prevents the Commissioner of Internal Revenue denying to him the deduction expressly allowed by Congress. In other words, the Commissioner in requiring the taxpayer to reduce his cost by the amount of the depletion and depreciation deduction granted by Congress, allows these annual deductions only *in case the asset is not sold.* If the asset is sold, the Commissioner deprives the taxpayer of this deduction by increasing his profit by the amount which Congress has said he may deduct from his income and forces him to pay a tax all in one year, at higher rates, on income earned over a period of years which was returned and taxed in accordance with the laws in effect for those years.

Doyle v. Mitchell Brothers Company, 247 U. S. 179.

The petitioner's brief on page 21, under subdivision 3, states,

> "The reason that cost or March 1, 1913, value is deducted from the sales price in determining gain or loss is to restore to the taxpayer his capital investment tax-free."

and cites *Doyle v. Mitchell Brothers Company, supra.* This Court decided that case on May 20, 1918, and in its opinion specifically limited it to the facts therein considered, namely, timber and acreage, saying, at page 188:

> "There is only a superficial analogy between this case and the case of an allowance claimed for depreciation of a mining property through the removal of minerals, since we have held that owing to the peculiar nature of mining property its partial exhaustion attributable to the removal of ores cannot be regarded as depreciation within the meaning of

> the act. *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 520, 524; *United States* v. *Biwabik Mining Co., ante*, 116; *Goldfield Consolidated Mines Co.* v. *Scott, ante*, 126."

On the same day the opinion in the *Mitchell Brothers* case was handed down the Court rendered its decision in the case of *Goldfield Consolidated Mines Company* v. *Scott, supra*, in which it specifically and unequivocally held that a mining corporation was not entitled to deduct "*any amount whatever*" on account of depletion or exhaustion of the ore bodies caused by its operations for the year for which the tax was assessed, and that there should not be allowed even a deduction from the gross proceeds from the mining and treatment of ores *to the extent of the cost value* of the ore in the ground before it was mined, ascertained in strict compliance with the rules and regulations of the Treasury Department. Counsel submits that the case of *Doyle* v. *Mitchell Brothers Company* is peculiar to itself.

Discussion of the petitioner's contentions regarding depreciation.

The government argues that depreciation (ordinary wear and tear) works a change in the *character* of property. This proposition we believe to be unsound. It seems to us that a building remains a building for all of depreciation. It may be a new building when bought and an old building when sold but nevertheless it is a building. True it is that the *value* may have lessened by the passage of time and by the ordinary wear and tear incident to use or caused by the elements. But a change in value is manifestly not a change in character.

If a building has depreciated in value through wear and tear, exhaustion or what not, or has enhanced in value for any reason whatsoever, these changes in value will be reflected in the sales price. If an increment in value due to economic causes is more than sufficient to offset the effects of wear and tear, a gain results—otherwise the effects of wear and tear reduce the market value and this reduction being reflected in the sales price, a loss results.

The petitioner in discussing this subject says on page 20,

> "While the depreciation was 'covered in the sale price', it was not 'covered in the cost'."

It is certain that depreciation would not be covered in the cost if the asset were new, there would have been no depreciation; and in the case of the sale after use, it is impossible to conceive of a purchaser buying without taking into account its then condition, which would of course comprehend depreciation.

The essential fact is that in order to determine the extent of depreciation *it is necessary* to compare the value of the property *new* or at the time acquired with the value of the property at any later date as the courts have held. *Nashville C. St. L. Ry. Co.* v. *U. S.*, 269 Fed. 351; certiorari denied, 255 U. S. 569.

Increment in value due to other causes may offset the depreciation due to wear and tear. We see nothing in *La Belle Iron Works* v. *U. S.*, 256 U. S. 377, contrary to this view.

The decision of the Board of Tax Appeals in the Appeal of Even Realty Company cited by the Solicitor General is in direct conflict with the decision of the United States District Court for the Northern District of Texas in the

case of *Ward, et al.* v. *Hopkins.* (U. S. Tax Cases 1571, not otherwise reported.) The Board's decision starts with the same false premise as does the petitioner, that depreciation is a return of capital, whereas it has been abundantly shown that it is not. In the Ward case the court held directly that in determining profit upon the sale of capital assets, depreciation sustained—whether or not deducted in computing income—should not enter into the computation.

We can see no support for the Government's contention in the two other cases which the Solicitor General cites, namely, *Henrici Company* v. *Reinecke*, 3 F. (2nd) 34; and *Kaufman-Straus* v. *Lucas*, 12 F. (2nd) 774.

The basis should not be reduced by any amount.

The proceeds of mining operations do not constitute a return of capital in whole or in part, but are income, and Congress was not required to make an allowance for depletion in computing annual net income from operations. *Goldfield Consolidated Mines Company* v. *Scott; Stratton's Independence* v. *Howbert; Stanton* v. *Baltic Mining Company; Commonwealth* v. *Ocean Oil Co., supra.* The mere fact that Congress, in the abundance of its powers, permitted in certain years, but not in all years, a limited deduction from annual gross income, which it was not required to make, on account of so-called depletion, does not change the character of the proceeds derived from the operation of oil properties. These proceeds, notwithstanding the allowance of a deduction, continue to represent earnings,—income. And a provision of Congress omitting in certain years to tax all or a part of these proceeds does not make them a return of capital.

The allowance granted by Congress for depletion was not and did not purport to be a return of capital. This is clearly shown by the earlier Acts and by the allowance of depletion based on discovery value in the later Acts. Cost represents capital and must be deducted in determining gain. Depletion represents not capital, but income, and therefore need not be deducted from the cost in determining gain on the sale of the fee. An allowance for depletion is merely the declination of Congress to tax all the income from mining or oil operations. It still remains an earning.

Conclusion.

The judgment of the Court of Claims should be affirmed.

Respectfully submitted,

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MARK J. RYAN,
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April, 1927.

SUPREME COURT OF THE UNITED STATES.

No. 289.—October Term, 1926.

United States, Petitioner, *vs.* Charles A. Ludey.	}	On Certiorari to the Court of Claims.

[May 16, 1927.]

Mr. Justice Brandeis delivered the opinion of the Court.

Ludey brought this suit in the Court of Claims to recover an amount exacted as additional taxes for 1917, under the income and excess profits provisions of the Revenue Act of 1916, September 8, 1916, c. 463, Title I, 39 Stat. 756, 757-759, as amended by the Revenue Act of 1917, October 3, 1917, c. 63, 40 Stat. 300, 329. The tax was assessed on the alleged gain from a sale in 1917 of oil mining properties which had been owned and operated by him for several years. The Commissioner of Internal Revenue determined that there was a gain on the sale of \$26,904.15. Ludey insists that there was a loss of \$14,777.33. The amount sued for is the tax assessed on the difference. Whether there was the gain or the loss depends primarily upon whether deductions for depletion and depreciation are to be made from the original cost in determining gain or loss on sale of oil mining properties. The question is one of statutory construction or application. The Court of Claims entered judgment for the plaintiff. 61 Ct. Cls. 126. This Court granted a writ of certiorari. 271 U. S. 651.

The properties consisted, besides mining equipment, in part of oil land held in fee, in part of oil mining leases. The aggregate original cost of the properties was \$95,977.33.[1] Of this amount \$30,977.33 was the cost of the equipment used in the business; \$65,000 the cost of the oil reserves. The 1917 sale price was \$81,200. For the purpose of determining the cost of the properties sold in 1917

[1] Some of the properties were purchased before March 1, 1913. As to these the term cost is used, throughout the opinion, as meaning their value as of March 1, 1913, that value being higher than the original cost.

the Commissioner deducted from the original cost $10,465.16 on account of depreciation of the equipment through wear and tear, and $32,258.81 on account of depletion of the reserves through the taking out of oil by the plaintiff, after March 1, 1913. There was no dispute of fact concerning the correctness of the estimates upon which these deductions were made. The finding of the depletion was in accordance with the method of computation employed by the Bureau of Internal Revenue; and there was no objection specifically to the method of computation. But Ludey insisted that the amount of depletion, if any, could not be found or stated as a fact, since, in the nature of the case, it was impossible to determine how much oil was recoverable either when he acquired the properties or when he disposed of them. The finding of the depreciation was, likewise, in accordance with the method of computation employed by the Bureau; and there was no objection to the method of computation. But Ludey insisted also in respect to depreciation that the property was, as a matter of law, unchanged in character and quantity throughout the period of operation.

Until 1924, none of the revenue acts provided in terms that, in computing the gain from a sale of any property, a deduction shall be made from the original cost on account of depreciation and depletion during the period of operation.[2] But ever since March 1, 1913, the revenue acts have required that gains from sales made within the tax year shall be included in the taxable income of the year, and that losses on sales may be deducted from gross income. And each of the acts has provided that, in computing the taxable income derived from operating a mine, there may be made a deduction from the gross income for the depreciation and that some deduction may be made for depletion. The applicable provisions of § 5 (a) of the Revenue Act of 1916 concerning deductions to be allowed in computing net income are these:

[2]The 1924 Act, June 2, 1924, § 202 (b), 43 Stat. 253, 255, provided that in computing gain or loss from sales, adjustment should be made for items of exhaustion, wear and tear, and depletion "previously allowed with respect to such property." See Regulations 65, Arts. 1591-1603. The 1926 Act, Feb. 26, 1926, § 202 (b), 44 Stat. 9, 11-12, has a similar provision with respect to deductions "allowable . . . under this Act or prior income tax laws." See Regulations 69, Art. 1561.

"Fourth. Losses actually sustained during the year, incurred in his business or trade . . . *Provided*, that . . the . . value of . . property [acquired before March 1, 1913] as of March 1, 1913, shall be the basis for determining the amount of such loss. . . .

"Seventh. A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade . .

"Eighth. (a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production . . (b) in the case of mines a reasonable allowance for depletion thereof . . : *Provided*, that when the allowances . . . shall equal the capital originally invested . . . no further allowance shall be made."

Ludey does not deny that Congress has power to require that deductions for depreciation and depletion shall be made from the original cost when determining the cost of oil properties sold. His contention is that, at the time of the sale in question, Congress had not in terms required the deductions in the case of any property and that special reasons exist why the acts should be construed as not requiring the deductions in the case of oil wells. He urges that a corporation organized for the purpose of utilizing a wasting property, like an iron mine, is not deemed to have divided a part of its capital, merely because it has distributed the net proceeds of its mining operations; that this is true even where the necessary result of the operation is a reduction of the mineral reserve; that, *a fortiori*, the proceeds of oil mining are to be deemed income, not a partial return of capital, since there is no ownership in oil until it is actually reduced to possession; that a purchase of an oil reserve cannot be likened to the purchase of a certain number of barrels of oil; that an oil reserve is not a reservoir; that Congress allowed the deduction from gross income for depreciation and depletion probably as a reward in an extrahazardous enterprise in order to encourage new producing properties; and that to allow the deductions would result, in the event of a sale of the property, in taking back the rewards so offered.

The Government contends that in operating the properties Ludey disposed, in the form of oil, of part of his capital assets; that in the extraction of the oil he consumed so much of the equipment as was represented by the depreciation and disposed of so much of the oil reserves as was represented by the depletion; that the sale of the properties made by him in 1917 was not a

sale of all of the property represented by the original cost of $95,977.33, since physical equipment to the amount of the depreciation and oil reserves to the amount of the depletion had been taken from it during the preceding years; and that, for this reason, the cost to plaintiff of the net property sold in 1917 was not $95,977.33, but $53,258.36.

The Court of Claims did not consider whether ordinarily deductions for depreciation and for depletion from the original cost would be proper in determining whether there had been a profit on a sale of property. It held that no deduction from original cost should be made here because of the nature of oil mining properties. The deduction for depletion was in its opinion, wrong, because oil properties are in essence merely the right to extract from controlled land such oil as the owner of the right can find and reduce to possession; because the existence of oil in any parcel of land is dependent upon the movement which the oil makes from time to time under the surface; and because whether there is oil in place which can be reduced to possession, and if so, how much, cannot be definitely determined. It held that, in the case at bar, the right to explore for and take out oil may actually have been more valuable at the time of the sale than at the time of the purchase; and that, for this reason, the removal of the oil by plaintiff during the years of operation cannot be said to have depleted the capital. It held that the depreciation was not deductible, because wear and tear of equipment was an expense or incident of the business.

We are of opinion that the revenue acts should be construed as requiring deductions for both depreciation and depletion when determining the original cost of oil properties sold. Congress, in providing that the basis for determining gain or loss should be the cost or the 1913 value, was not attempting to provide an exclusive formula for the computation.[3] The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order

[3]See *Appeal of Even Realty Co.*, 1 B. T. A. 355. Compare *Appeal of Steiner Coal Co.*, 1 B. T. A. 821; *Appeal of W. W. Carter Co.*, 1 B. T. A. 849; *Appeal of Keighley Mfg. Co.*, 2 B. T. A. 10.

that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties.[4] Any other construction would permit a double deduction for the loss of the same capital assets.

Such being the rule applicable to manufacturing and mercantile businesses, no good reason appears why the business of mining should be treated differently. The reasons urged for refusing to apply the rule specifically to oil mining properties seem to us unsound. If the equipment had been used by its owner on the oil properties owned by another, it would hardly be contended that the depreciation through wear and tear resulting from its use should be ignored in determining, on a sale of the equipment, whether its owner had made a gain or a loss. The fact that the equipment sold is owned by the person who owned the mining rights, like the fact that it is used in one class of mining rather than in another, may have an important bearing both upon the price realized on the sale and upon the rate of depreciation which should be allowed: but these facts cannot affect the question whether the part which has been theretofore consumed by use shall be ignored in determining whether a sale of what remains has resulted in a loss or a gain.

The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year

[4]Under regulations of the Bureau the amount of the year's depreciation is required to be fixed in accordance with a reasonably consistent plan; and it must, in order to be allowed, have been entered on the books of the business either as a deduction from the book value of the plant or as a credit to a depreciation reserve account. See Regulations 33 Revised, Art. 159; Regulations 45, Art. 169; Regulations 62, Art. 169; Regulations 65, Art. 169; Regulations 69, Art. 169. In either event it would be reflected in the annual balance sheet. After the total of such credits equals the original cost no further deduction is allowed.

represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed. The fact that the reserve is hidden from sight presents difficulties in making an estimate of the amount of the deposits. The actual quantity can rarely be measured. It must be approximated. And because the quantity originally in the reserve is not actually known the percentage of the whole withdrawn in any year, and hence the appropriate depletion charge, is necessarily a rough estimate. But Congress concluded, in the light of experience, that it was better to act upon a rough estimate than to ignore the fact of depletion.

The Corporation Tax Law of 1909 had failed to provide for any deduction on account of the depletion of mineral reserves. *Stratton's Independence* vs. *Howbert,* 231 U. S. 399; *von Baumbach* v. *Sargent Land Co.,* 242 U. S. 503; *United States* v. *Biwabik Mining Co.,* 247 U. S. 116; *Goldfield Consolidated Mines Co.* v. *Scott,* 247 U. S. 126. The resulting hardship to operators of mines induced Congress to make provision in the Revenue Law of 1913 and all later Acts for some deduction on account of depletion in determining the amount of the taxable income from mines.[5] It is not lightly to be assumed that Congress intended the fact to be ignored in determining whether there was a loss or a gain on a sale of the mining properties. The proviso limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction is to be regarded as a return of capital, not as a special bonus for enterprise and willingness to assume risks. It is argued that, because oil is a fugacious mineral, it cannot be known that the reserve has been diminished by the operation of wells. Perhaps some land may be discovered which, like the Widow's cruse, will afford an inexhaustible supply of oil.

[5]The Bureau requires that taxpayers claiming depletion deductions shall keep a ledger account in which deductions claimed are credited against the cost of the property, or that a depletion reserve account be set up. See Regulations 33 Revised, Art. 171, 172; Regulations 45, Art. 216; Regulations 62, Art. 216; Regulations 65, Art. 217; Regulations 69, Art. 217.

But the common experience of man has been that oil wells, and the territory in which they are sunk, become exhausted in time. Congress in providing for the deduction for depletion of oil wells acted on that experience. Compare *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364. In essence, the deduction for depletion does not differ from the deduction for depreciation.

The Court of Claims erred in holding that no deduction should be made from the original cost on account of depreciation and depletion; but it does not follow that the amount deducted by the Commissioner was the correct one. The aggregate for depreciation and depletion claimed by Ludey in the income tax returns for the years 1913, 1914, 1915 and 1916, and allowed, was only $5,156. He insists that more cannot be deducted from the original cost in making the return for 1917. The contention is unsound. The amount of the gain on the sale is not dependent on the amount claimed in earlier years. If in any year he has failed to claim, or has been denied, the amount to which he was entitled, rectification of the error must be sought through a review of the action of the Bureau for that year. He cannot choose the year in which he will take a reduction. On the other hand, we cannot accept the Government's contention that the full amount of depreciation and depletion sustained, whether allowable by law as a deduction from gross income in past years or not, must be deducted from cost in ascertaining gain or loss. Congress doubtless intended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer was entitled to deduct in the several years.

The findings do not enable us to determine what that aggregate is. The sale included several properties purchased at different times. The deduction allowable in the several years for each of the properties is not found. Under the Act of 1913 the full amount of the depletion was not necessarily deductible. In order that the amount of the gain in 1917 may be determined in the light of such facts, the case is remanded for further proceedings in accordance with this opinion.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.